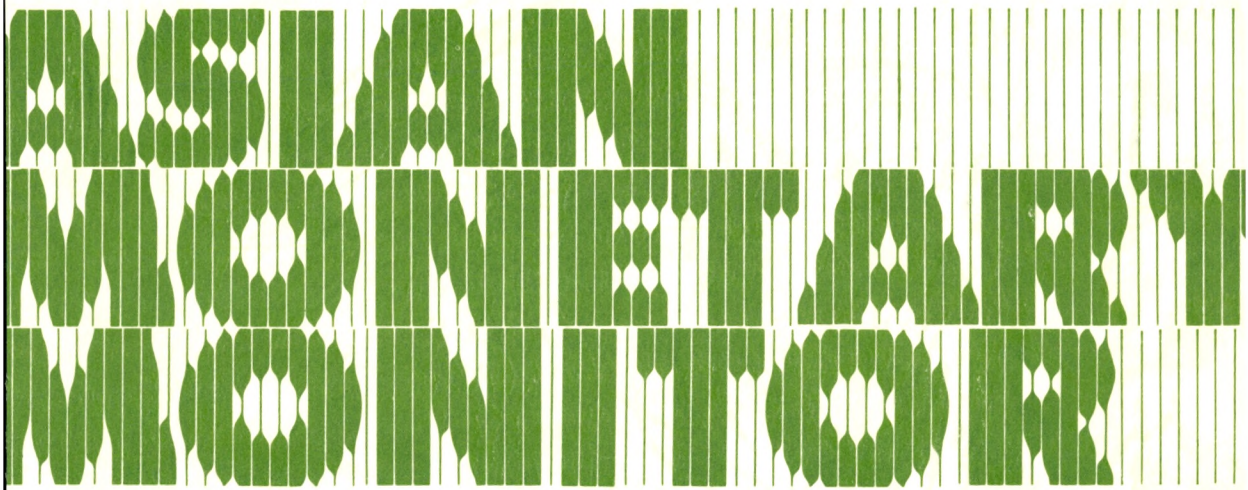




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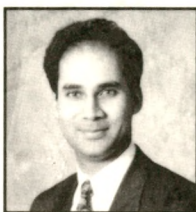




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REGIONAL SURVEY STATISTICAL REVIEW OF ASIAN CURRENCIES AFTER MEXICO

This note provides a brief account, along with supporting statistical data, of recent currency turbulence in South East Asia. It deliberately does not discuss the prospects for Asian currencies following devaluation of the Mexican Peso, an issue which has elicited considerable attention from regional commentators. The note ends with implications for regional policy formulation of the significant interest rate premia that attach to Asian currencies post-Mexico.

Statistical background

Exchange rate turbulence in the region since November 1994 can be broadly attributed to two main factors: the ongoing sell-off in Asian capital markets and, lately, heightened speculator attention in the wake of the Mexican financial crisis. A crude indication of the extent and duration of turbulence, seen mainly in January 1995, can be gauged from table 1, and the attached charts (1-6). Foreign exchange movements in China, Korea and Taiwan are subject to tight capital controls which are likely to distort statistical interpretation; they are, therefore, excluded from the present survey.

Columns of 3 and 4 of Table 1 show percentage ranges within which nominal exchange rates in the region have moved (i) in the period since November 1994 and (ii) in the period since June 1994. The first period is coincident with sharp falls in regional equity markets and includes market turbulence associated with devaluation of the Mexican Peso on December 19. The second period is extended to include movements between June and October 1994, a five month stretch of relative calm on Asian currency exchanges, except perhaps for the Philippines Peso and Malaysian Ringgit, mainly influenced by ongoing uncertainty over the regional impact of further US monetary policy tightening. Taken together the two columns provide a crude measure of nominal currency volatility in the period since November 1994 and confirm the view that, in most cases, currency swings in the period were significant when measured over a seven month horizon. The most obvious exception to this general observation is the Malaysian Ringgit, which actually experienced relative stability in three months to the end of January 1995 -- in sharp contrast to its erratic movements between June and October 1994.

Two other factors are worth observing: (i) the proximity of average nominal exchange rates in column 1 to the median for the period (shown in brackets) is an indication that a degree of exchange rate stability was returned soon after the crisis period in January -- the "crisis" in Asia was short-lived; and (ii) currency competitiveness on a purchasing power parity basis remained broadly unchanged (see footnotes to table 1 below).

While all currencies in the survey were subject to additional turbulence in the period following the Mexican devaluation, the sharp sell-off in Hong Kong's stockmarket placed unusually strong, albeit brief, pressure on the Hong Kong dollar (HK\$). The HK\$, which up to November 1994 had been trading narrowly in a range around 7.7250 against the

Table 1

All exchange rates against the US\$:

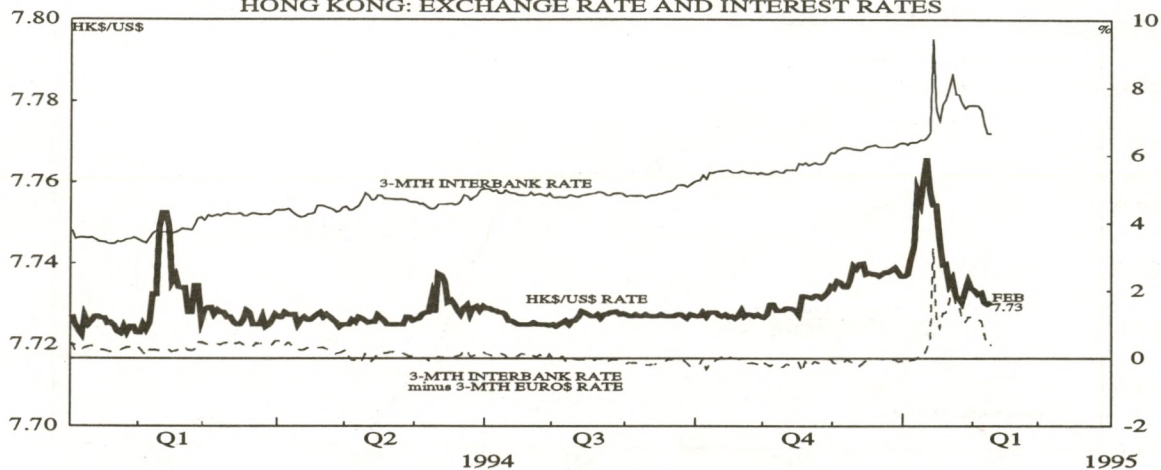
	Indicative nominal exchange rate average for Jan 95 ⁽¹⁾	Nominal range Nov 94-Jan 95 ⁽²⁾	% range movement Nov 94- Jan 95	% range movement Jun 94- Jan 95	PPP exchange rate estimates ⁽³⁾
Hong Kong dollar	7.7434 (7.746)	7.7274-7.7655	(0.5%)	(0.5%)	7.15 (Oct)F
Malaysian Ringgit	2.5552 (2.5564)	2.5470-2.5658	(0.7%)	(9.4%)	2.37 (Nov)-
Indonesian Rupiah	2216.1 (2223.0)	2171.03-2275	(4.8%)	(5.3%)	1727.5 (Oct)-
Thai Baht	25.10 (25.04)	24.92-25.16	(1.0%)	(1.4%)	25.3 (Dec)F
Singapore dollar	1.4531 (1.4611)	1.4475-1.4745	(1.9%)	(4.4%)	1.39 (Nov)-
Philippines Peso	24.59 (24.38)	23.75-25.00	(5.3%)	(13.1%)	29.7 (Nov)+

- (1) based on daily closing exchange rates. Figures in brackets are median exchange rates based on column 2.
- (2) daily closing exchange rates
- (3) A previous article ("Regional Survey: Asian Currency Valuations" in July-August 1992) explored the competitiveness of Asian currencies including an evaluation of appropriate price indices: CPI, WPI, EPI to be employed in each country. Column 5 uses identical methodology but extends the series to include subsequent price and nominal exchange rate movements. The letters and symbols indicate: F = fair value, + = overvalued, - = undervalued. Months in brackets show latest available price indices. Computations based on monthly average exchange rates.

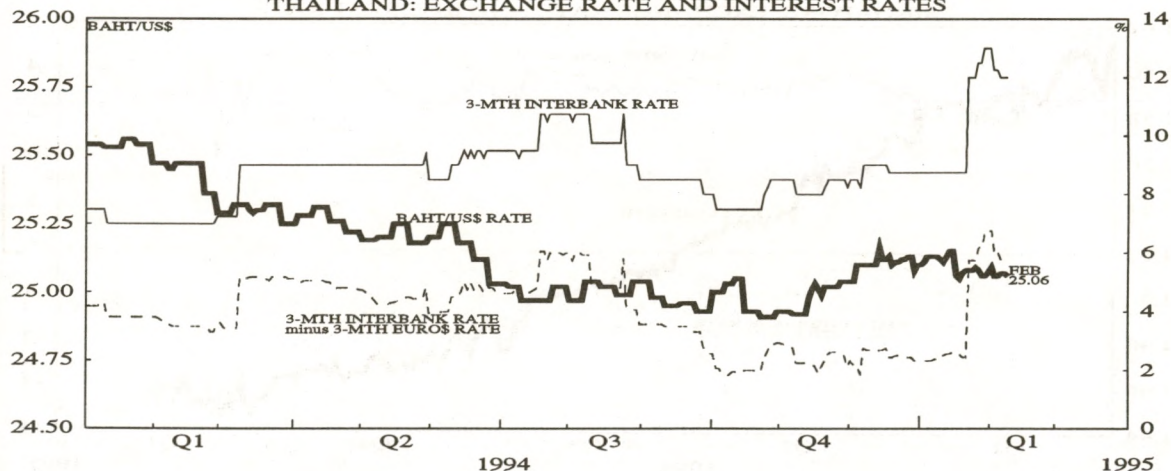
US\$ weakened gradually to 7.7350 by the end of December. Pressure intensified on 9 January as the HK\$ moved above 7.76 in London and New York, pushing one year forward rates to the weak side of the HK\$7.80 link rate, and widening forward risk premia across all maturities. Hong Kong's Monetary Authority responded immediately, draining substantial amounts of liquidity from the banking system through formal operation of the Account arrangements, pushing overnight interest rates to 15% on occasions. The overnight interest rate, measured at the close of business peaked at 6% on 17 January but has gradually eased since then.

In an attempt to penalise speculative short positions, monetary conditions were allowed to tighten throughout East Asia, mainly as a result of unsterilised foreign exchange rate intervention by regional central banks. In response to a sharp fall in the Thai Baht on 12-13 January, tight money in Thailand was supplemented by the subsequent announcement of a strong exchange rate "fix", contrasting with the tendency for the fix to weaken over the past year, and demonstrating the authorities' resolve to counter speculative threats with the reserve armoury. Since the January crisis, exchange rate fixes have shown a tendency to undershoot market expectations -- implying an effective, if only slight, depreciation of the Baht. Liquidity however was tightly squeezed throughout the turbulent period forcing the Bank of Thailand to re-open its swap loan facility on a selective basis.

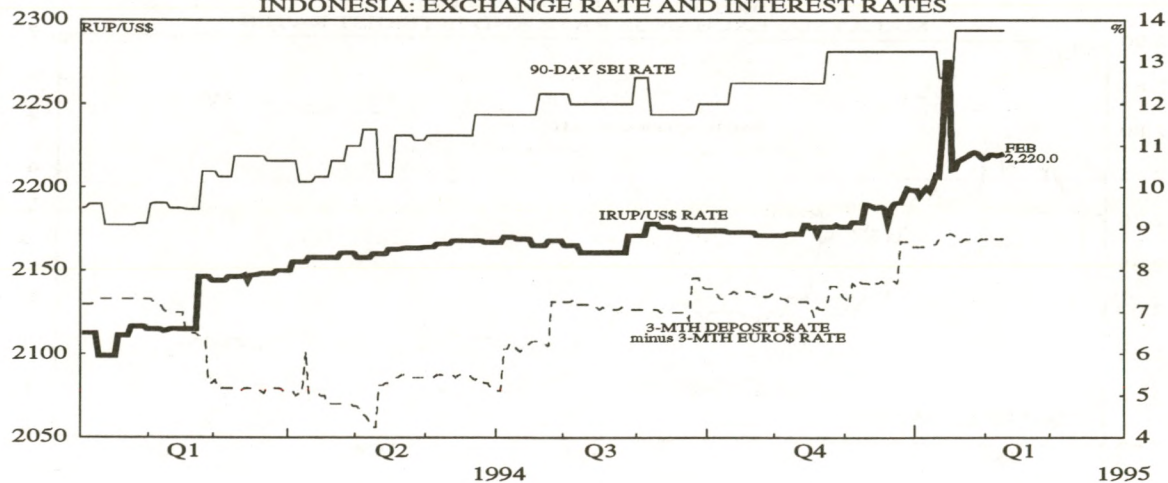
REGIONAL SURVEY: CHART 1
HONG KONG: EXCHANGE RATE AND INTEREST RATES



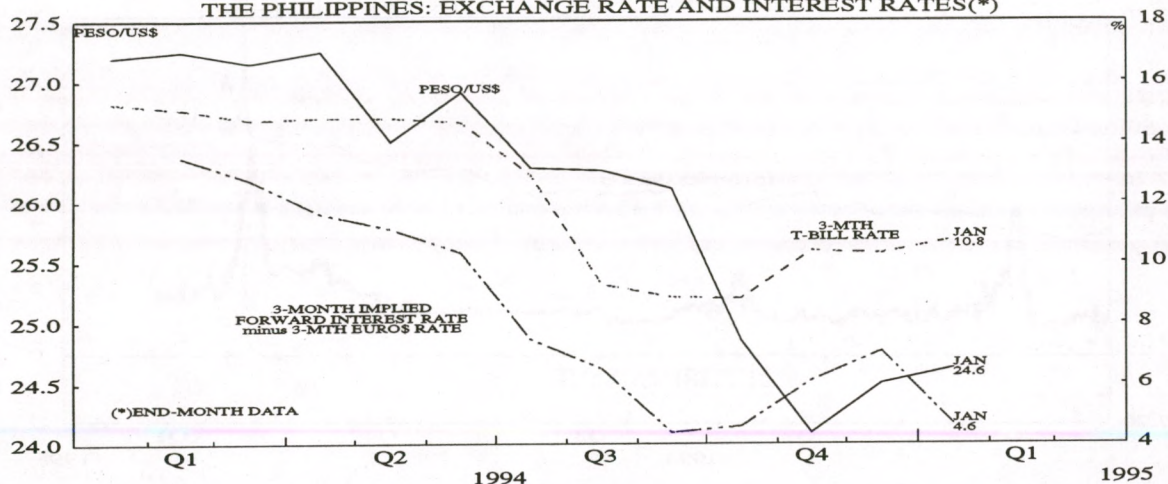
REGIONAL SURVEY: CHART 2
THAILAND: EXCHANGE RATE AND INTEREST RATES



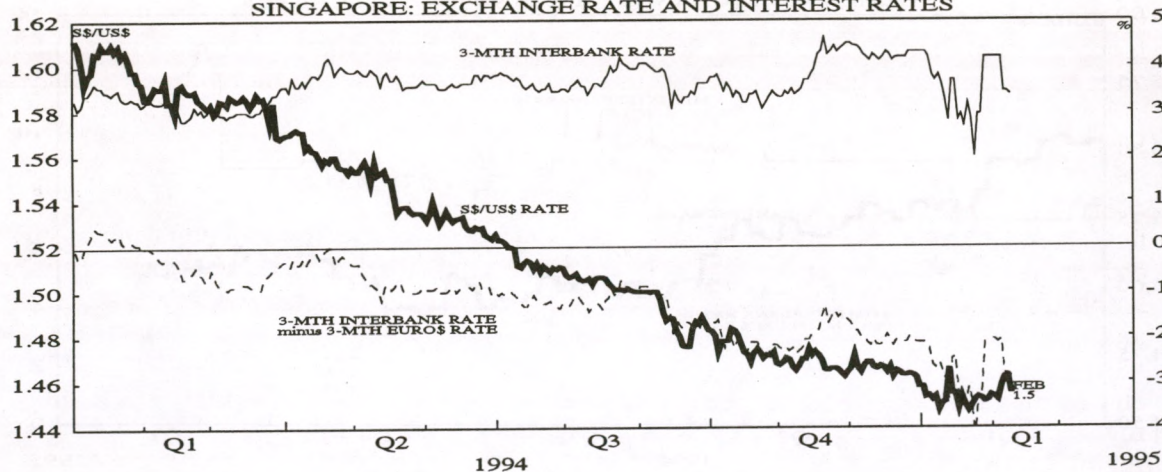
REGIONAL SURVEY: CHART 3
INDONESIA: EXCHANGE RATE AND INTEREST RATES



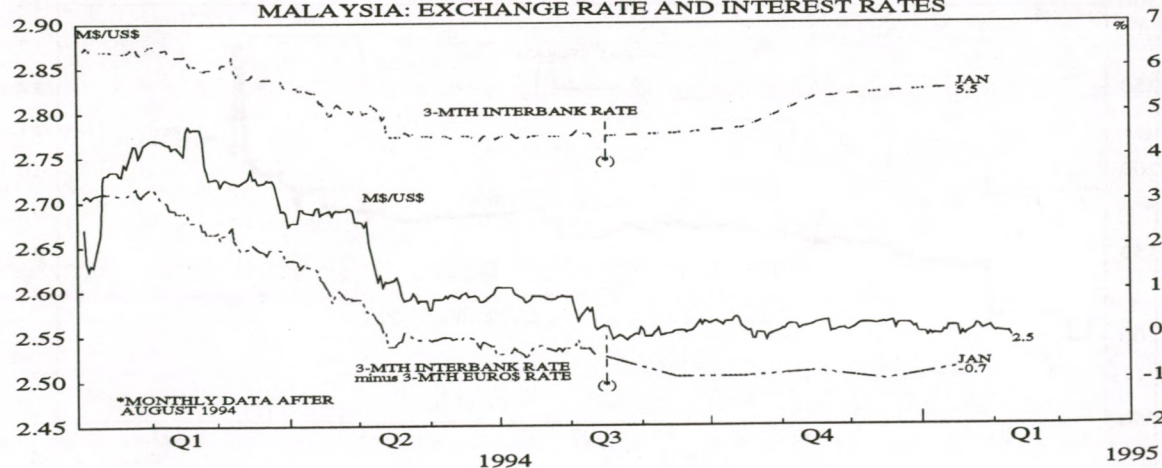
REGIONAL SURVEY: CHART 4
THE PHILIPPINES: EXCHANGE RATE AND INTEREST RATES(*)



REGIONAL SURVEY: CHART 5
SINGAPORE: EXCHANGE RATE AND INTEREST RATES



REGIONAL SURVEY: CHART 6
MALAYSIA: EXCHANGE RATE AND INTEREST RATES



Elsewhere in Asia, the Indonesian currency was allowed to drift to record intra-day lows, around Rupiah 2300 before central bank intervention (reportedly) restored its value to around 2200. Faced with heavy selling pressure on the Philippines Peso, domestic banks responded to a move of the Peso outside its 1.5% permissible limits by suspending computerised foreign exchange trading for two hours on 9 January. Thereafter the Peso elicited some central bank support. Even the S\$ (considered to be the safehaven currency of Asia) did not escape entirely unscathed as it depreciated briefly before stabilising on 16 January.

Currency Speculation

Given the short duration of Asian currency instability in January, it is pertinent to review characteristics of local money markets which potentially deter the currency speculator. Speculative activity in a currency will generally be limited if trading volumes, and liquidity outside its country of origin are low. Furthermore, the relatively tight monitoring of trading activity by domestic central banks acts as a strong disincentive especially during periods of high volatility. In the Philippines, for instance, currency trading is conducted through a computerised exchange allowing the central bank to monitor large value trades and corresponding counterparties very closely -- a job made easier by the normally low volumes. In a similar vein, the fear of sudden capital controls, particularly during periods of high uncertainty is likely to dampen significant speculator interest. Underpinning these factors is the sharply raised interest rate cost of covering and hedging short forward exchange rate contracts, the traditional vehicle for exchange rate speculation.

Risk Premia

While the turbulence described above may have been short-lived, the Mexican crisis has left Asian currency exchanges calm but uneasy: evidenced by the attachment of significant and widened interest rate premia across Asia (see Table 2 below). Interest rate premia are the higher return needed in order to take on greater uncertainty associated with credit and market risks; they are constantly adjusted as efficient markets re-appraise risk scenarios in light of new information. In this sense, risk premia post-Mexico reflect not only enhanced uncertainty about investment in Asian assets generally but also constantly changing risk perceptions (upwards and downwards) as the market continues to scrutinise the region for parallels with Mexico.

Table 2

Implied 3-month forward interest rate premia over US\$ (1):

	End-October 94	End-January 95
	%	%
Hong Kong dollar	-0.003	+1.2
Malaysian Ringgit	-1.13	-0.8
Indonesian Rupiah	+7.7	+7.3
Thai Baht	+2.3	+5.1
Singapore dollar	-1.8	-3.8
Philippines Peso	+4.6	+4.6
3-Month Euro\$ rate	5.56	6.25

- (1) 3-month forward interest rates are implied from the relevant 3 month forward exchange rates. They may, therefore, differ significantly from equivalent money market rates that are shown in the attached charts.

This poses a challenging task for regional policy makers; if they believe the similarities between Asian economies and Mexico to be superficial, then policy predictability will clearly diminish an element of uncertainty, but only if this is coupled with policy consistency (no obvious conflict between domestic and external policy objectives -- macroeconomic and political), and overall credibility (a consistent policy will be pursued). In the context of predictability, it is encouraging to note that local exchange rate support by regional central banks, coupled with stern action on interest rates and clear statement of policy, was well received by the currency markets. However, consistency and credibility in the field of economic policy formulation are established over much longer time horizons (cf. twenty years of less than 6% average annual inflation in Germany), but can be damaged very quickly. For the moment, Asian currencies have been extended the benefit of the doubt, albeit at higher cost to domestic economies in terms of tighter monetary conditions. In most cases, externally induced monetary tightening has been judged by the market to be timely and consistent with counter-inflationary tightening, given strong regional growth and fundamentals in recent years. In the longer term, Asian currencies may be troubled again by the perception of diminished growth momentum as a result of a prolonged liquidity squeeze.

SUMMARY AND CONCLUSIONS: The brief statistical overview in this article has argued that the recent bout of currency turbulence in Asia, associated with the sell-off in regional capital markets and the Mexican crisis, was brief, but significant in the context of very recent history. The currency exchanges remain calm but uneasy as the jury on the case of Asia vs Mexico remains undecided. Evidence of this can be seen in the enhanced and constantly adjusting interest rate risk premia which now attach to investments in Asian assets. In response policy makers will need to answer currency market uncertainty by demonstrating policy predictability, consistency and credibility over a prolonged period. The main long term threat in this context may derive from the need to maintain tight monetary conditions, in order to defend currencies, far longer than is necessary (or politically acceptable) by reference to domestic fundamentals. In the short-term, however, externally induced monetary tightening across Asia could be argued as convenient and consistent with prudent, and perhaps pre-emptive, measures to counter incipient inflationary threats.

AUSTRALIA PROGRESSING TOWARDS THE FINAL STAGES OF THE UPSWING

Introduction

Australia is about to enter its fifth successive year of recovery, during which time it has enjoyed an inflation rate which has not exceeded 2% and a high, although declining unemployment rate: an almost unbelievable performance given past inflationary episodes. For the first three years of this recovery (from early 1991 to late 1993) both long and short term nominal interest rates declined and remained at historically low levels. However in early 1994 bond markets awoke with a jolt and suddenly the cost of long term funds to borrowers (such as the government) leapt. By Autumn of 1994, the nominal 10 year bond yield exceeded 10% and the mounting strength in real economic indicators prompted the Reserve Bank of Australia (RBA), under the watchful eye of the government, to begin to tighten monetary policy (or rather make it less relaxed).

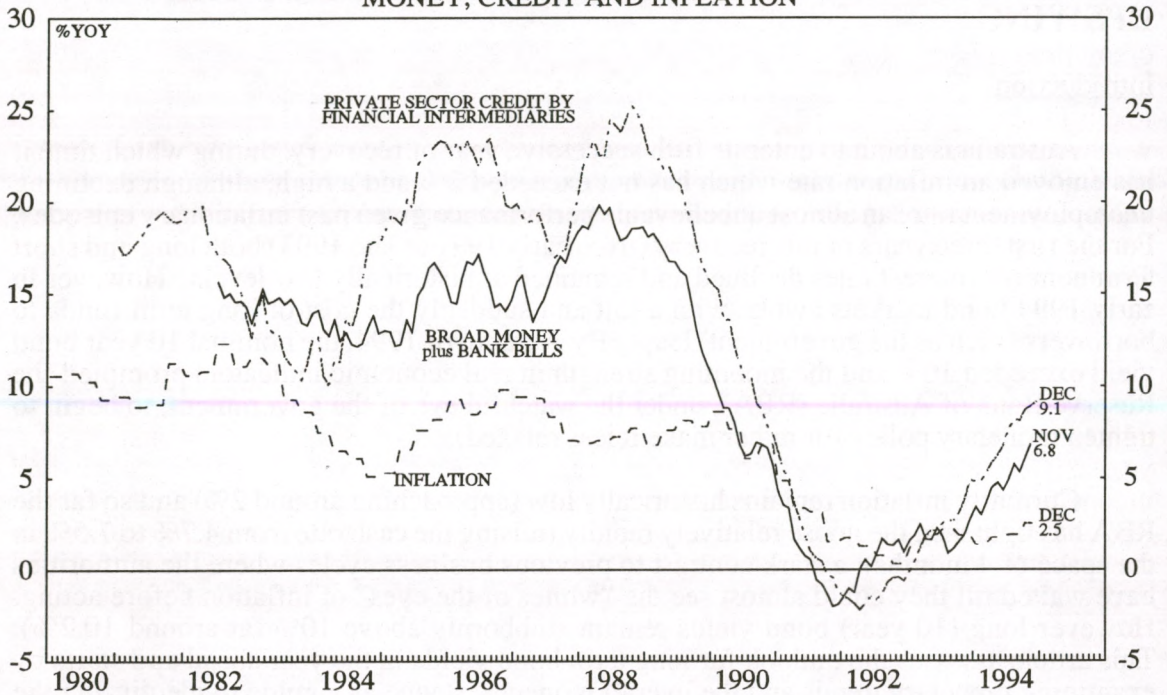
Currently inflation remains historically low (approaching around 2%) and so far the RBA has tightened the noose relatively rapidly (raising the cash rate from 4.7% to 7.5% in the space of 4 months): a stark contrast to previous business cycles where the authorities have waited till they could almost see the "whites of the eyes" of inflation before acting. However long (10 year) bond yields remain stubbornly above 10% (at around 10.2%). This article assesses the outlook for long term bond yields in the year ahead and starts by examining monetary trends and the overall monetary stance as a guide to identifying the likely turning point in real GDP growth and inflationary expectations. This in turn provides an indication of the likely trends in import demand and the current account deficit. Notwithstanding the currently low inflationary environment, the strength in the real economy, the trends in trade and, the stance of monetary policy imply that the bond market is unlikely to rally in the first half of this year and may weaken later in the year unless the RBA raises short rates in the months ahead. However, if short rates rise so as to invert the yield curve this will lay the ground for a mild rally in the bond market.

Monetary Policy and Prospective Trends in Monetary Growth

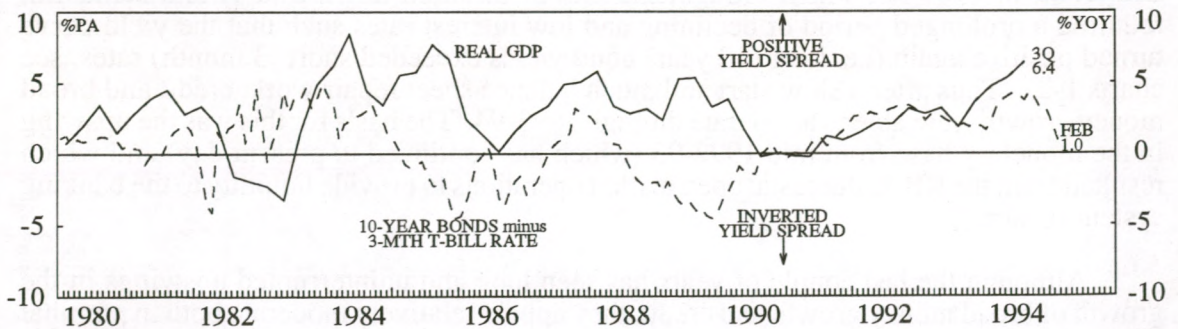
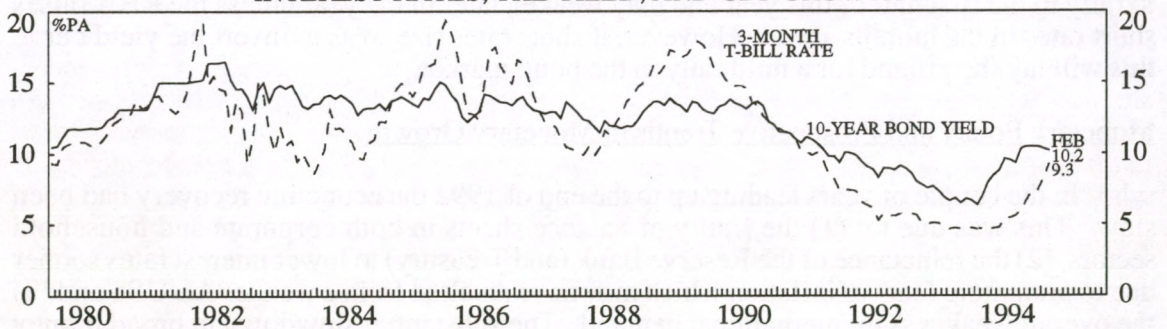
In the couple of years leading up to the end of 1992 the economic recovery had been slow. This was due to: (1) the frailty of balance sheets in both corporate and household sectors, (2) the reluctance of the Reserve Bank (and Treasury) to lower interest rates sooner due to premature fears of inflation which may have resulted from a weaker A\$/US\$ and (3) the overall weakness in international demand. The substantial slowdown in broad money and credit in 1989-90, which brought the rate of inflation down to a virtual standstill, required a prolonged period of declining and low interest rates such that the yield curve turned positive again (i.e. long (10 year) bond yields exceeded short (3 month) rates, see charts 1-2). Thus after a slow start and much balance sheet repair work, credit and broad money growth were able to accelerate through 1993-94. The basis for this was the upswing in the monetary base from mid 1992-93 (which has continued to present day) and which resulted from the RBAs domestic open market operations to provide liquidity to the banking system (Chart 3).

Although the last couple of years has seen long and uninterrupted upswings in the growth of broad money growth and credit, they appear relatively moderate both in nominal and real terms when compared with those upswings in 1984 and 1987 (Chart 1). Part of

AUSTRALIA: CHART 1
MONEY, CREDIT AND INFLATION



AUSTRALIA: CHART 2
INTEREST RATES, THE YIELD, AND GDP GROWTH



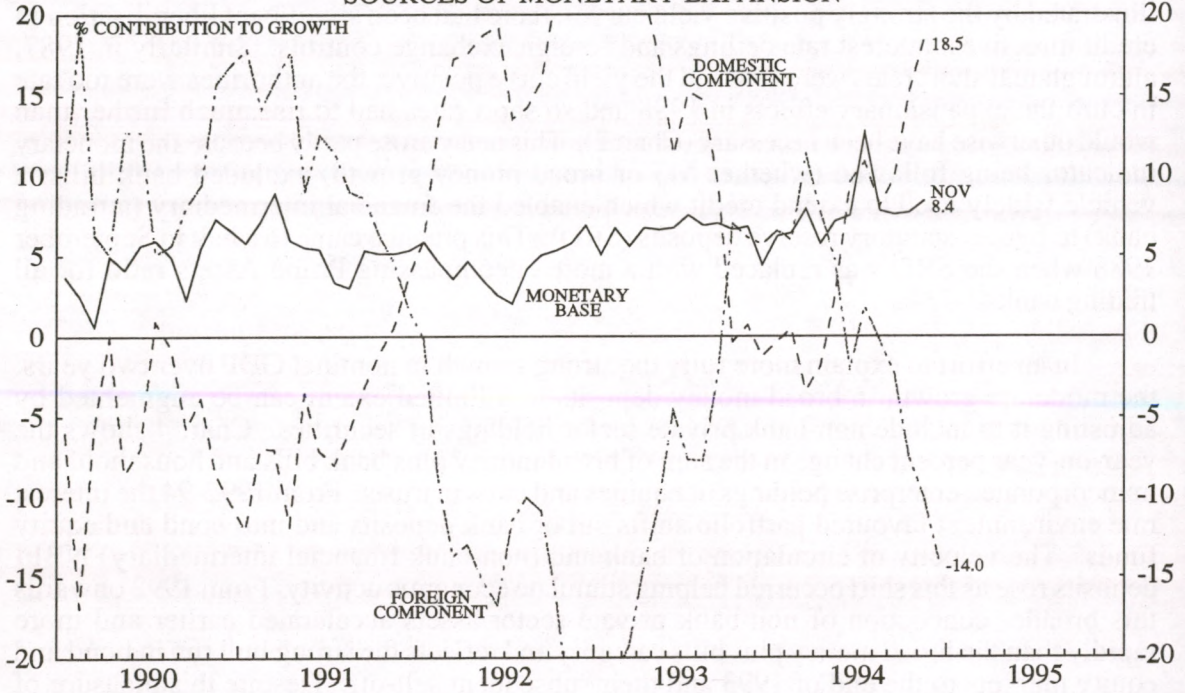
the reason for this lies in the qualitative differences in previous episodes of monetary acceleration. In the years leading up to 1984, while credit conditions were stimulative (as illustrated by the strongly positive yield curve), there had been significant liberalisation in credit directives, interest rate ceilings and foreign exchange controls. Similarly in 1987, although real short rates were low and the yield curve positive, the authorities were too late to curb the expansionary effects in 1988 and so short rates had to rise much further than would otherwise have been necessary (Chart 2). This delay arose partly because the monetary indicator being followed (whether M3 or broad money growth) excluded bank bills: a vehicle widely used to extend credit which enabled the financial intermediary (a trading bank) to bypass statutory reserve deposits (SRD). This practice came to a halt in September 1988 when the SRD was replaced with a more encompassing Prime Assets ratio for all trading banks.¹

In an effort to explain more fully the strong growth in nominal GDP over two years, the moderate growth in broad money deposits to a limited extent can be augmented by adjusting it to include non-bank private sector holdings of securities. Chart 4 shows the year-on-year percent change in the sum of broad money plus bank bills and household and unincorporated enterprise holdings of equities and units in trusts. From 1992-94 the interest rate environment favoured portfolio shifts out of bank deposits and into bond and equity funds. The velocity of circulation of bank and (non-bank financial intermediary) NBFIs deposits rose as this shift occurred helping stimulate economic activity. From 1992 onwards this broader concoction of non-bank private sector assets accelerated earlier and more rapidly than the broad money plus bills category and reflects the strong bull run in bond and equity markets to the end of 1993 and their subsequent sell-off. Despite this measure of non-bank private sector assets being more representative of the expansion in nominal GDP growth, it suffers from the major flaw that it is inflated or deflated according to the value of the stock and capital markets (as well as capturing the shift in private sector savings from bank deposits towards holdings of securities). Given the potential sensitivity of the adjusted series to changes in the prices of bonds and shares alone, it is difficult to assess the extra degree of explanatory power (of GDP) afforded by this construct. However with short rates rising and the yield curve flattening in the second half of 1994 this deposit shift process should begin to reverse. The velocity of circulation of bank and non-bank deposits will fall as redemptions of funds translate into a resurgence in the growth of broad money deposits in the banking system. Broad monetary growth is therefore likely to continue to accelerate while this shift continues before slowing in response to further RBA tightening.

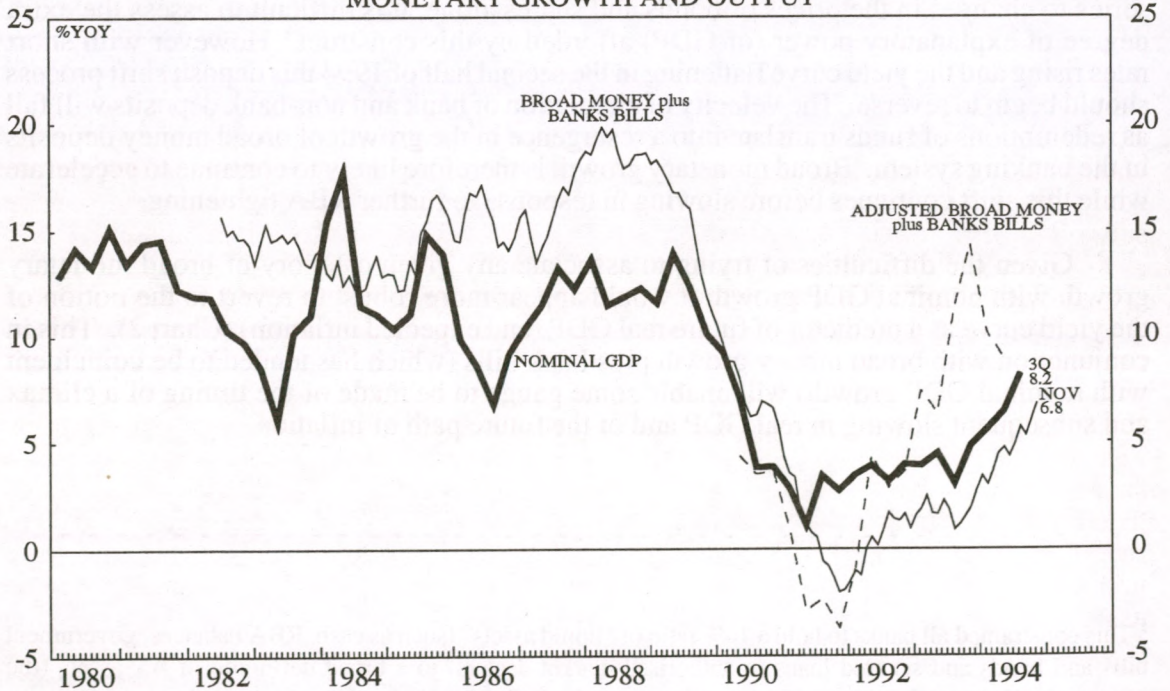
Given the difficulties of trying to associate any given category of broad monetary growth with nominal GDP growth it would appear more robust to revert to the notion of the yield curve as a predictor of future real GDP (and expected inflation) (Chart 2). This in conjunction with broad money growth plus bank bills (which has tended to be coincident with nominal GDP growth) will enable some gauge to be made of the timing of a climax and subsequent slowing in real GDP and of the future path of inflation.

¹ This constrained all banks to hold a 10% ratio of "liquid assets" (such as cash, RBA balances, government bills and bonds and secured loans to authorised market dealers) to a broad definition of A\$ assets (the aggregate of banks A\$ assets within Australia except for defined capital and overnight settlement balances). This ratio has since been reduced to 6%, mainly in 1990 during the year of major financial difficulties.

AUSTRALIA: CHART 3
SOURCES OF MONETARY EXPANSION



AUSTRALIA: CHART 4
MONETARY GROWTH AND OUTPUT



Interest Rates and the Changing Term Structure

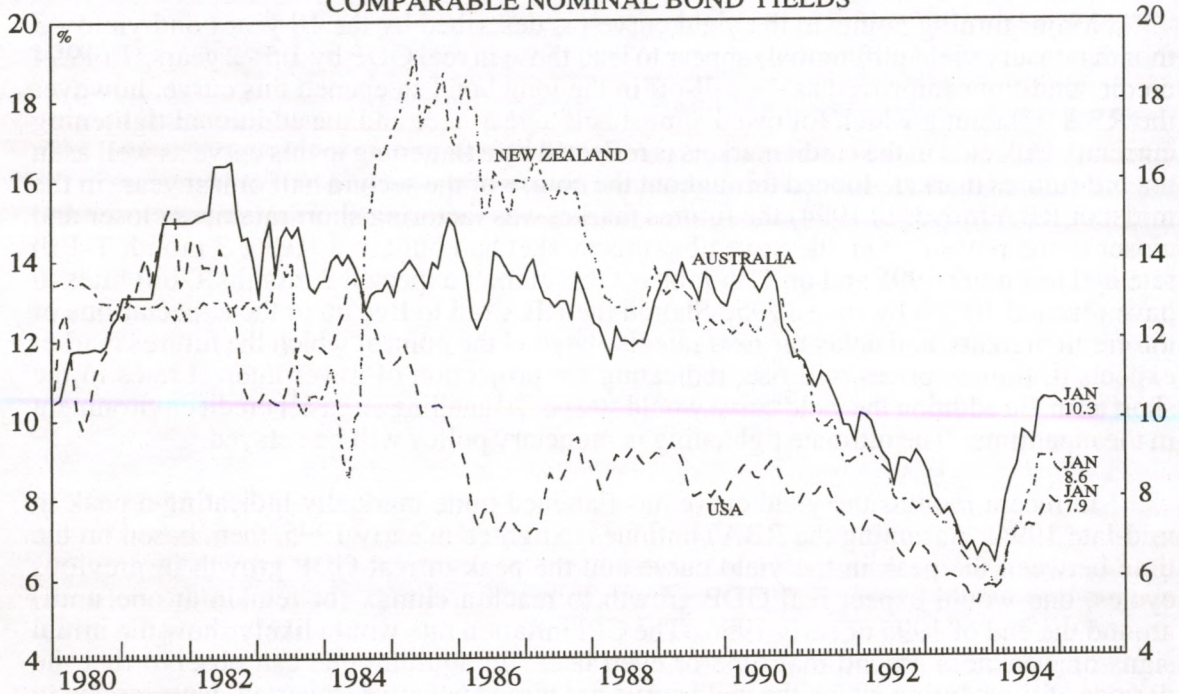
Major turning points in the yield curve (as described by the 10 year bond yield - 3 month treasury yield differential) appear to lead those in real GDP by 1.5 - 2 years. In 1994 credit conditions improved as the sell-off in the long bond steepened this curve, however the RBA tightening which followed almost half a year later and the additional tightening currently expected in the credit markets is reflected by a flattening in this curve as well as in the bill futures market. Indeed throughout the course of the second half of last year (in the midst of RBA moves in 1994) the futures market was factoring short rate rises closer and closer to the present. On 8th November this market had built in a 10.5% 3 month T-Bill rate by December 1995 and on 11th January this market expected 3 months T-bill rates to have reached 10.5% by June 1995. Should the RBA fail to live up to the expectations of the credit markets, and delay the next rate rise beyond the point at which the futures market expects it, futures prices will rise, indicating the projection of lower interest rates in the short term. In addition the yield curve would steepen, signalling an easier credit environment in the meantime. The ultimate tightening in monetary policy will be delayed.

In recent months the yield curve has flattened quite markedly indicating a peak in mid-late 1994. Assuming the RBA continues to tighten in early 1995, then, based on the time between the peak in the yield curve and the peak in real GDP growth in previous cycles, one would expect real GDP growth to reach a climax (or remain at one until) around the end of 1995 or early 1996. The CPI inflation rate would likely show the initial signs of weakness around that time or even later. In addition one can observe that the periods of time during which the yield curve has turned negative (inverted) have tended to coincide with a peaking out and deceleration in the growth of broad money plus bills and in broad credit i.e. it becomes penally expensive to "borrow short" and "lend long".

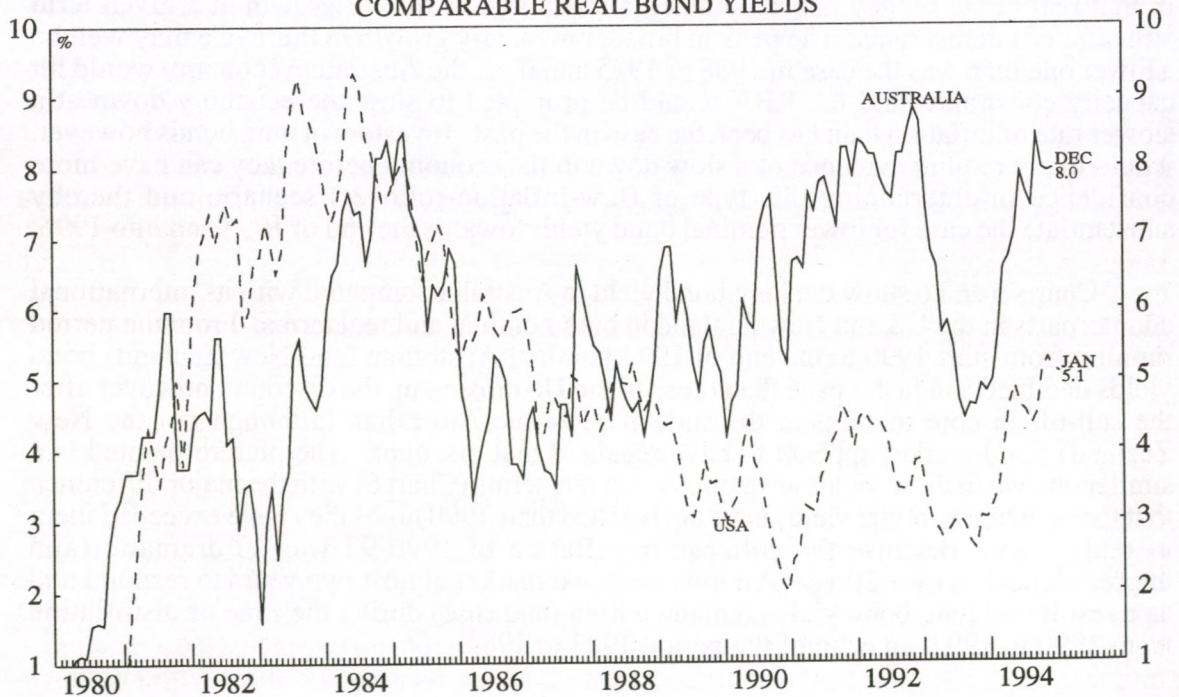
As mentioned earlier this business cycle can be differentiated from the previous two in that real broad money has maintained a much slower rate of growth at a given term structure of interest rates. The peak in broader monetary growth in this cycle may well be a lower one than was the case in 1988 or 1985 and if so, the Australian economy would hit capacity constraints and the RBA would be prompted to slow the economy down at a slower rate of inflation than has been the case in the past. Investors in long bonds however, would likely require evidence of a slow down in the economy before they can have more confidence in entertaining this type of (low-inflation-rollover) scenario and thereby substantiate the case for lower nominal bond yields towards the end of 1995 and into 1996.

Charts 5 and 6 show the long bond yield in Australia compared with its international counterparts in the US and New Zealand in both nominal and real terms. From the period running from start 1990 to the end of 1993 nominal Australian (and New Zealand) bond yields declined at a faster pace than those in the US closing up the discount, however after the sell-off in core markets at the start of 1994 the Australian (although not the New Zealand) bond market appears to have regained that discount. The picture painted is a similar one when these yields are expressed in real terms (Chart 6) with the major difference that today, while nominal yields have not reached their 1990 highs they have exceeded them in real terms. Because the collapse in inflation in 1990-92 was so dramatic (and unprecedented in over 20 years) it took the bond market almost two years to respond and as a result real long bond yields remained high (and rose) during the time of disinflation from 1990 to 1992, an echo of the period 1983 to 1984.

AUSTRALIA: CHART 5
COMPARABLE NOMINAL BOND YIELDS



AUSTRALIA: CHART 6
COMPARABLE REAL BOND YIELDS



The sell-off in long bonds in 1994 pushed up real yields back to their 1992 highs. This is likely to constitute a cyclical high similar to that in 1984-85 for two reasons. First, inflation will likely nudge up by 1-2% and erode nominal yields in the next 12 months. Nominal yields are unlikely to back up much farther (given a benign outlook for long yields in the US) and given that there are further rises in Australian short rates which lead to an inverted yield curve. Second, conditional on the yield curve analysis discussed earlier, the cyclical peak in inflation in this business cycle is unlikely to be as high as it has been at the top of past cycles. Consequently (if the RBA continues to tighten) there is scope for nominal yields to rally (as inflation reaches its climax) by 1-2% following a slowing in economic activity (probably late in 1995 or early 1996). This would bring real yields to the 4-5% range by then. Crucial to all this analysis is whether and when the RBA is likely to move to restrict monetary policy further. This is now discussed in the context of the state of the real economy.

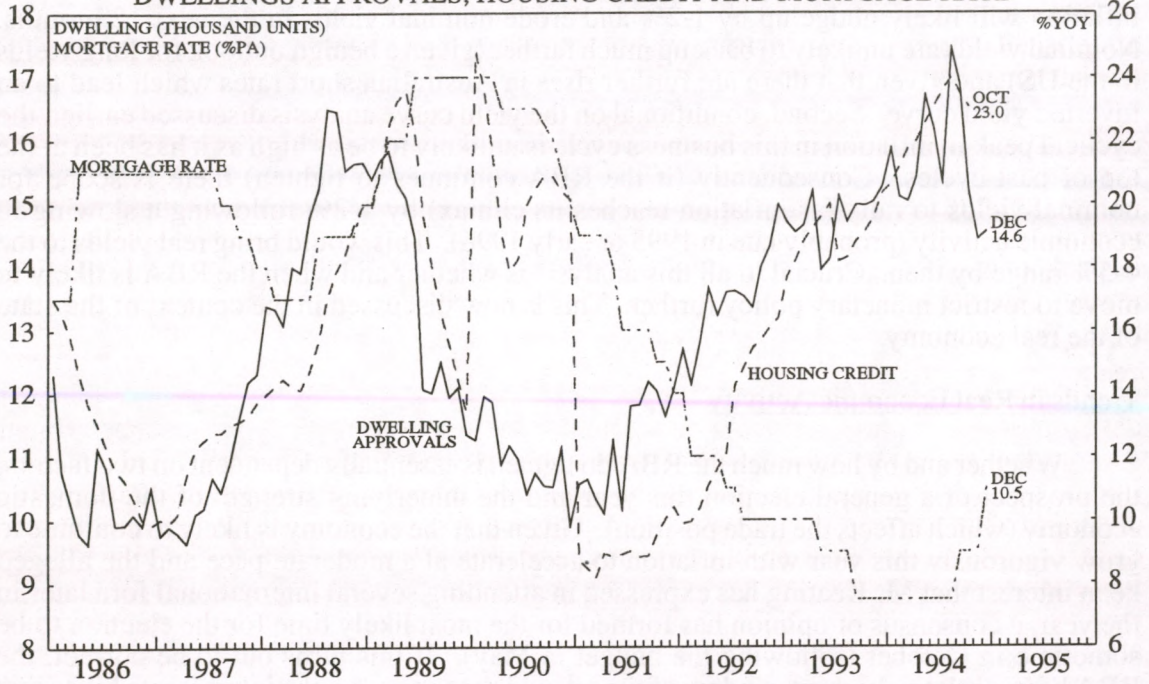
Trends in Real Economic Activity

Whether and by how much the RBA do tighten is essentially dependent on two factors: the prospect of a general election this year and the underlying strength of the domestic economy (which affects the trade position). Given that the economy is likely to continue to grow vigorously this year with inflation to accelerate at a moderate pace and the alleged keen interest that Mr Keating has expressed in attending several international fora later in the year, a consensus of opinion has formed for the most likely time for the election to be sometime in October (following the budget in May). If this turns out to be correct, the RBA have a relatively short window of time in which to carry out the interest rate hikes that would be necessary to invert the yield curve and restrain credit through the whole of 1995. Failure to do this in the coming months would potentially forfeit the opportunity to squeeze credit conditions until the end of the year, by which time the economy would likely require larger short rate hikes to accomplish the same task.

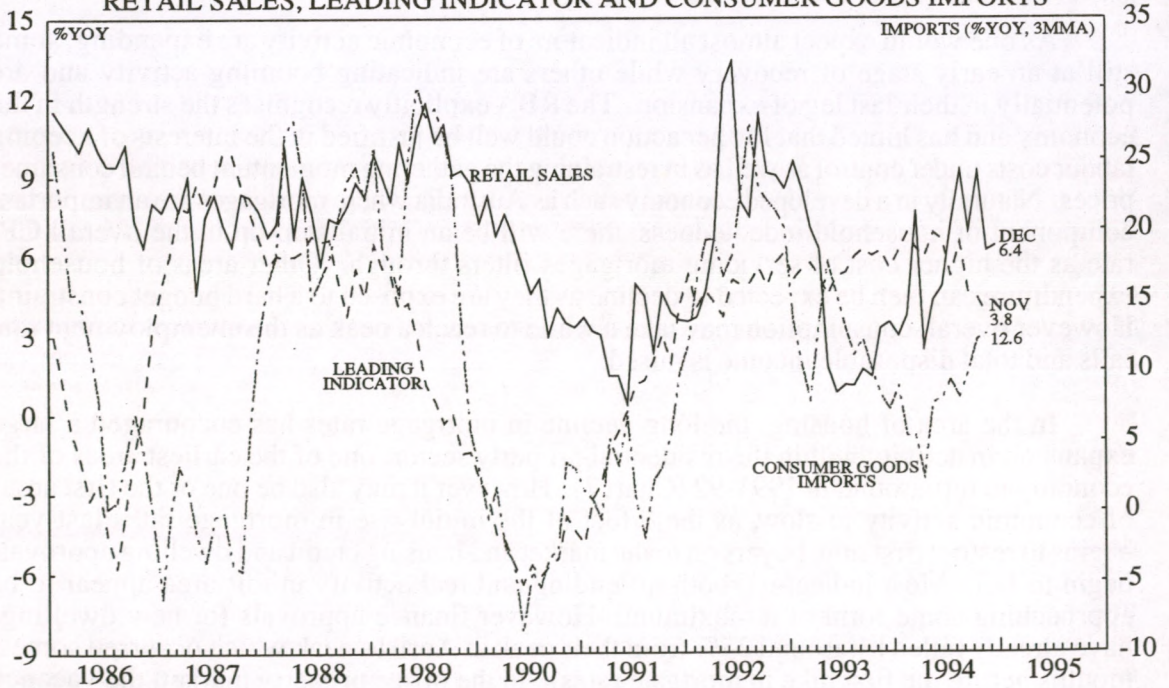
As one would expect almost all indicators of economic activity are expanding, some still at an early stage of recovery while others are indicating booming activity and are potentially in their last leg of expansion. The RBA explicitly recognises the strength in the economy and has hinted that further action could well be justified in the interests of keeping labour costs under control as well as in restraining the gathering momentum behind consumer prices. Naturally in a developed economy such as Australia where mortgages are an important component of household indebtedness, there will be an initial step-up in the overall CPI rate as the higher cost of servicing mortgages filters through. Other areas of household expenditure can then be expected to decline as they are exposed to a hard budget constraint. However overall consumption may take a while to reach a peak as the unemployment rate falls and total disposable income is raised.

In the area of housing, the long decline in mortgage rates has encouraged a large expansion in activity within the residential property sector: one of the earliest areas of the economy to turnaround in 1991-92 (Chart 7). However it may also be one of the first areas of economic activity to slow, as the effect of the initial rise in mortgage rates last year begins to restrict first time buyers on to the market and housing credit and dwelling approvals begin to fall. Most indicators, both of lending and real activity in this area appear to be approaching some form of a maximum. However finance approvals for new dwellings have already fallen by around 25% from their peak in April (a peak which occurred some 5 months before the first hike in mortgage rates). In the office property market, the vacancy rates have declined from their peaks in 1992. In Sydney the vacancy rate in prime office

AUSTRALIA: CHART 7
DWELLINGS APPROVALS, HOUSING CREDIT AND MORTGAGE RATE



AUSTRALIA: CHART 8
RETAIL SALES, LEADING INDICATOR AND CONSUMER GOODS IMPORTS



space has declined from a peak of around 23% to 17%, while average office rentals have stabilised after declining by around 30% from a high point in 1990. Indicators of consumption such as consumer imports, retail sales and consumer spending remain strong or are firmly established on an upward trend (Chart 8). The (Westpac) leading indicator is not showing any sustained signs of weakness.

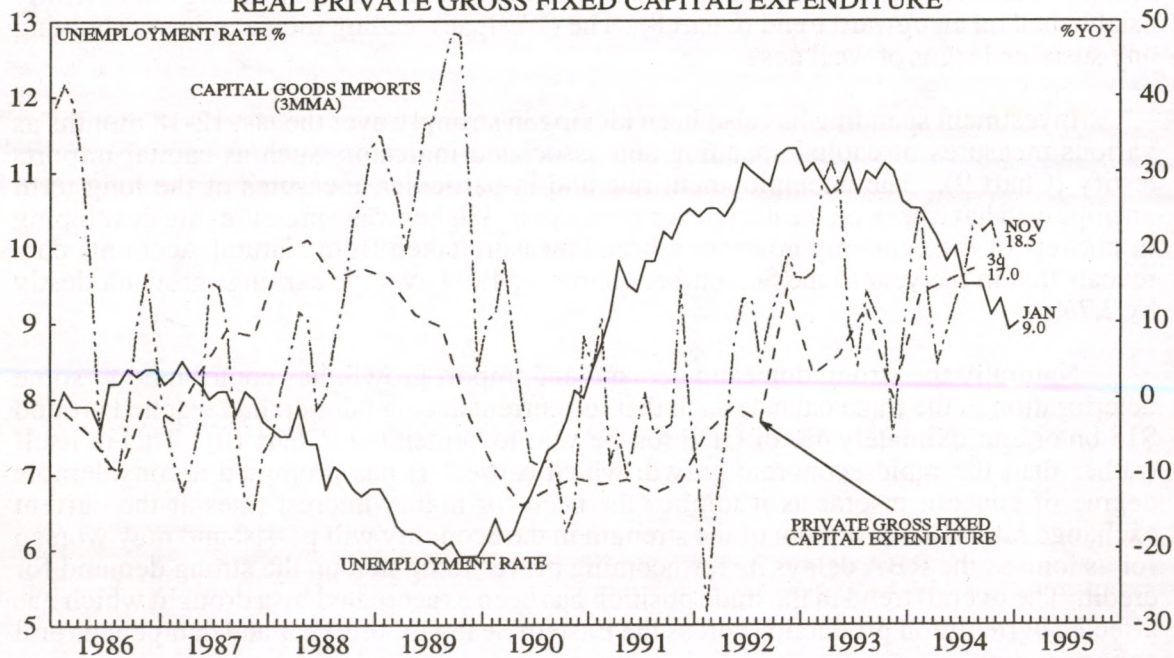
Investment spending has also been kicking in strongly over the last 12-18 months as various measures of capital spending and associated indicators such as capital imports testify (Chart 9). The unemployment rate and in particular, measures of the long term unemployed have been on the decline for over a year. Higher wage pressures are developing in pockets of the economy however a broad measure taken from Natural Accounts data reveals that in the year to the September quarter of 1994 average earnings grew modestly by 2.7%.

Naturally the strong domestic demand and import growth has contributed to some deterioration in the trade balance such that the current account deficit had reached around \$18 bn or approximately 4% of GDP for the year to September (Chart 10). This in itself (rather than the rapid economic growth which caused it) has prompted a considerable degree of concern insofar as it implies the need for higher interest rates at the current exchange rate. This symptom of the strength in the economy will persist and may worsen for as long as the RBA delays its forthcoming moves to tighten up the strong demand for credit. The overall trend in the trade position has been exacerbated by a drought which has affected agricultural production across the Eastern Seaboard this year and dampened rural export growth.

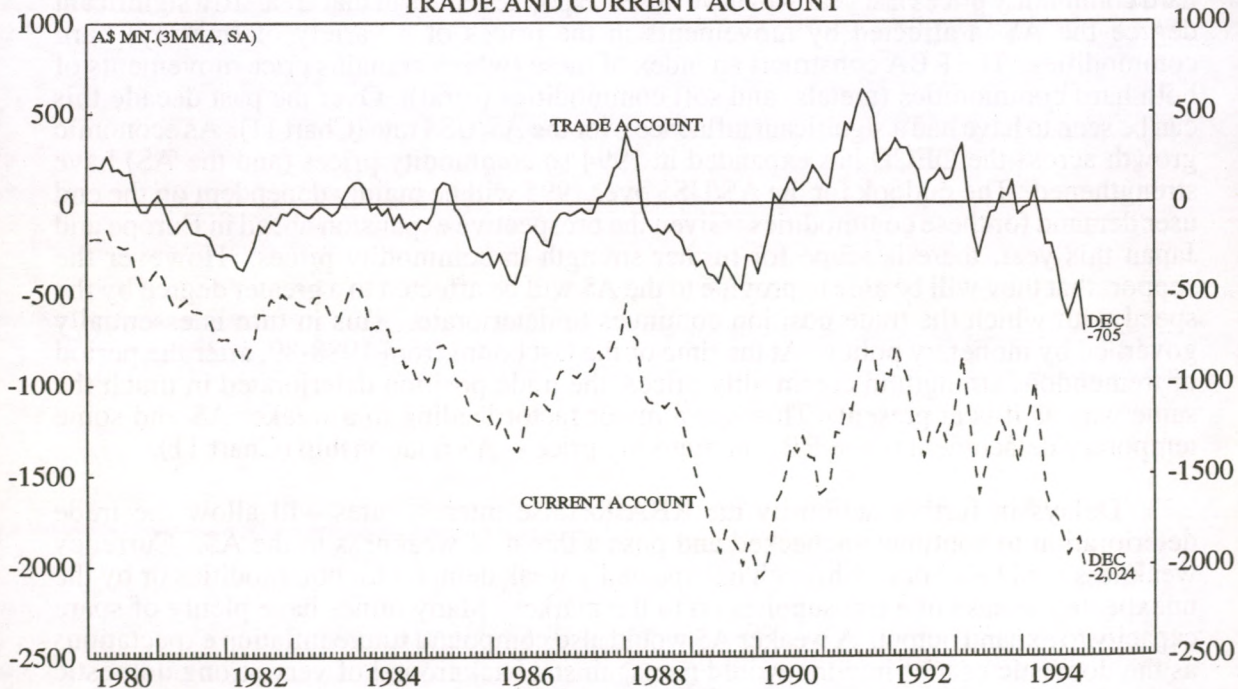
However there have been two factors which have offset the overall effect of the drought on the current account deficit. First, the impact of the strength in the A\$ last year has been to reduce the net external debt stock. Second, the impact of the strength in most hard commodity prices last year will have raised export revenues in that area. To a significant degree the A\$ is affected by movements in the prices of a variety of (mainly) hard commodities. The RBA constructs an index of these (which contains price movements of both hard commodities (metals) and soft commodities (rural). Over the past decade this can be seen to have had a significant influence over the A\$/US\$ rate (Chart 11). As economic growth across the OECD has expanded in 1994 so commodity prices (and the A\$) have strengthened. The outlook for the A\$/US\$ over 1995 will be mainly dependent on the end user demand for these commodities. Given the prospective expansion ahead in Europe and Japan this year, there is scope for further strength in commodity prices. However the support that they will be able to provide to the A\$ will be affected to a greater degree by the speed with which the trade position continues to deteriorate. This in turn is essentially governed by monetary policy. At the time of the last boom from 1988-89, after the period of tremendous strength in commodity prices, the trade position deteriorated in much the same way as it is at present. This was a major factor leading to a weaker A\$ and some temporary detachment in the RBA commodity price -- A\$ relationship (Chart 11).

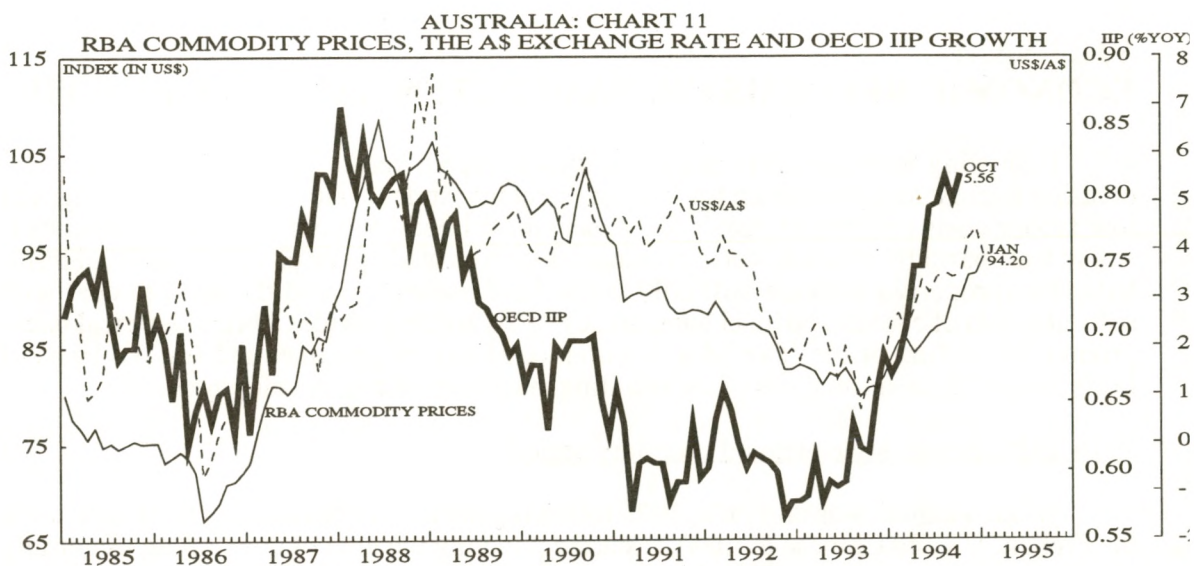
Delays in further action by the RBA to raise interest rates will allow the trade deterioration to continue unchecked and pose a threat of weakness to the A\$. Currency weakness could also occur through unexpectedly weak demand for commodities or by the unexpected release of extra supplies on to the market. Many mines have plenty of spare capacity to expand output. A weaker A\$ would also compound future inflation expectations as the domestic cost of imports would rise against a background of very strong domestic demand. As a result, looking ahead the RBA is likely to be more sensitive to any persistent weakness in the A\$ than it may have been in the earlier stages of the economic recovery.

AUSTRALIA: CHART 9
UNEMPLOYMENT RATE, CAPITAL GOODS IMPORTS AND
REAL PRIVATE GROSS FIXED CAPITAL EXPENDITURE



AUSTRALIA: CHART 10
TRADE AND CURRENT ACCOUNT





Hence if the RBA continue to tighten in the near term they are unlikely to encounter these problems and if they manage to invert the yield curve they will likely succeed in keeping inflationary pressures at bay in 1996 and thereby clear the way for a modest bond rally after comprehensive signs of a slowing begin to emerge. This would entail some turnaround in the trade position. By contrast not acting to tighten monetary policy would entail running the risk of a much more bloated trade deficit by the end of the year, a higher inflation rate with more momentum behind it, requiring much more aggressive monetary tightening and possibly a shortened overall monetary cycle. This would obviously be an unhealthy environment for long bond investments and make progress in the equity market more difficult.

SUMMARY AND CONCLUSIONS: The Australian economy continues to barrel along at a rapid pace and some of the more interest rate sensitive indicators may weaken in the next few months if the RBA continues to raise interest rates. Raising short term interest rates so as to generate an inverted yield curve sometime in 1995 would likely be necessary to slow down the growth of credit and economic growth providing scope for a modest rally in nominal bond yields possibly in late 1995 early 1996. However there are likely to be numerous elections (both state and perhaps a general one) this year so according to the "unwritten convention" the RBA would be powerless to tighten at this time. This leaves it with a relatively short window of time in which to act in the immediate months ahead (although the effect of higher rates could well be politically cushioned by a slack budget and generous spending packages this May). Hence, although judging from the "shopping list" of indicators of economic strength it has referred to, the RBA recognises the need for a further squeeze, this may not happen till late 1995. This opens the door to the host of risks for investors associated with an overheating economy.

In particular in the absence of further tightening the economy will continue to grow vigorously throughout 1995 and well into 1996 generating a persistent and possibly widening current account deficit over this time accompanied by a faster inflation rate. This economic response to slack monetary policy would also likely result in a markedly weaker A\$/US\$ and a further sell-off in bond yields by Autumn 1995. This would require much more aggressive action to squeeze credit growth late this year and the likelihood of maintaining the historically low inflation rate in the 2-4% region by the end of 1995 and during 1996 would be remote. Naturally this scenario entails a choppy time ahead for both bond and equity markets as they would continue to react adversely to worsening economic news.

VIETNAM

ECONOMIC REFORMS UNLEASH POTENTIAL FOR GROWTH

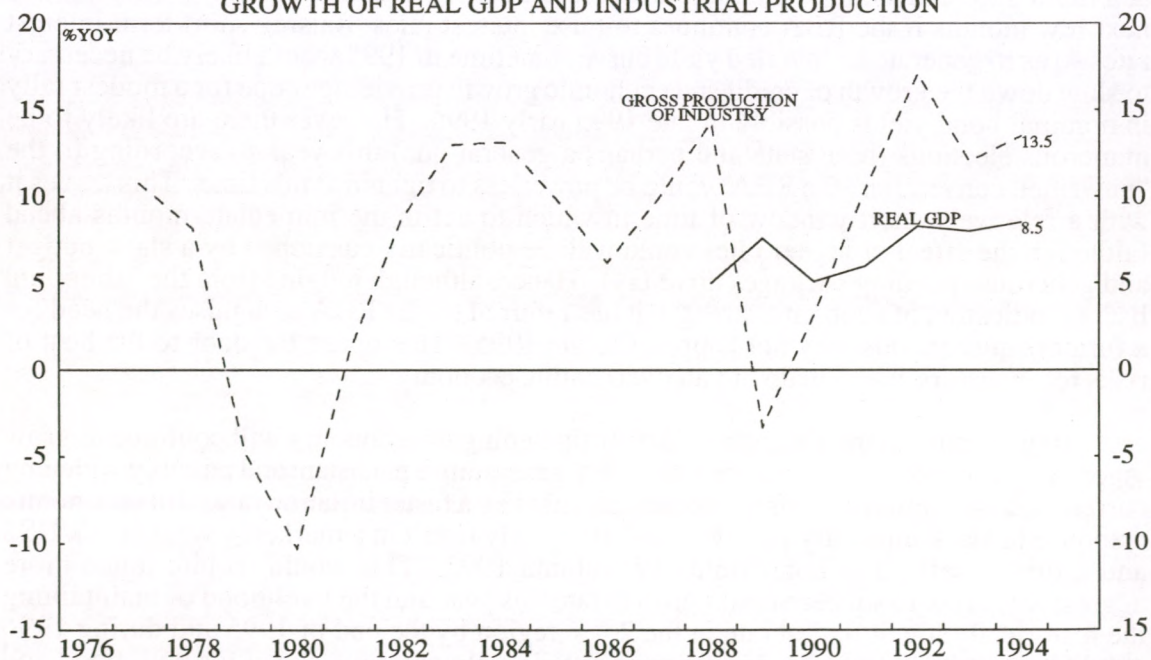
Following impressive economic reforms in recent years, Vietnam has attracted increasing interest as a destination for foreign direct investment. However, the advantages of low labour costs and one of Asia's (on paper) most liberal foreign investment regimes is still at least partially offset by various obstacles such as inadequate physical and legal infrastructure (property rights are still only vague land-use rights) and the need to deal with several layers of central and local bureaucracy. This article provides a brief historical background, an outline of the 'Doi Moi' economic reform programme, and (on the basis of fairly limited data) an analysis of the resulting macro-economic developments.

1976-1986: Soviet-style planned economy period

When Vietnam was unified in 1976 following decades of devastating wars (defeating the French, US and Chinese armies), it started pursuing the goal of developing a centrally planned socialist economy. This development path was, however, fraught with numerous difficulties. The inefficiencies of central planning were initially only addressed in an inadequate piecemeal manner, the plan was in any case undermined by the reluctance of local authorities to relinquish the high degree of autonomy associated with decades of guerrilla warfare, the emphasis on political dogma wasted essential and scarce skilled labour in re-education and stifled individual economic incentives, and deteriorating international relations led to increased isolation and loss of desperately needed development assistance. In 1986 the economy reached crisis point, with a slump in industrial output and retail sales, and the official retail price inflation accelerating to 400% year-on-year. In December that year, following 10 years of limited economic success, the government announced the introduction of the 'Doi Moi' (renewal) programme of economic reforms.

VIETNAM: CHART 1

GROWTH OF REAL GDP AND INDUSTRIAL PRODUCTION



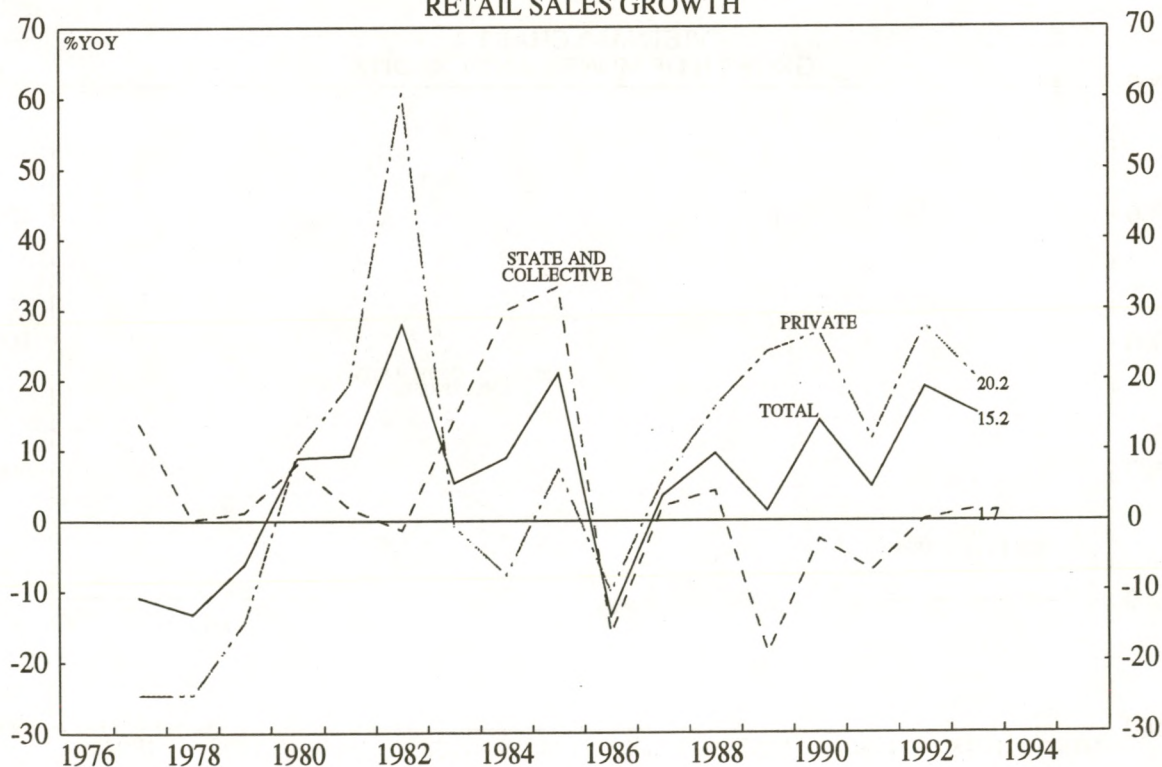
1987-1994: 'Doi Moi' reform programme

In 1987, prices of non-essential consumer goods were adjusted upwards to be slightly less out of line with international (and black market) prices, and the rationing system was phased out on all products except rice and kerosene. The previous state monopoly on the trade and transport sector was broken down and private sector involvement was allowed to encourage a more efficient distribution of goods around the country. These adjustments to the price mechanism, however, did not prevent retail price inflation from remaining in triple digits, and necessitated a devaluation from 128 to 225 VND (Vietnamese Dong) per US\$.

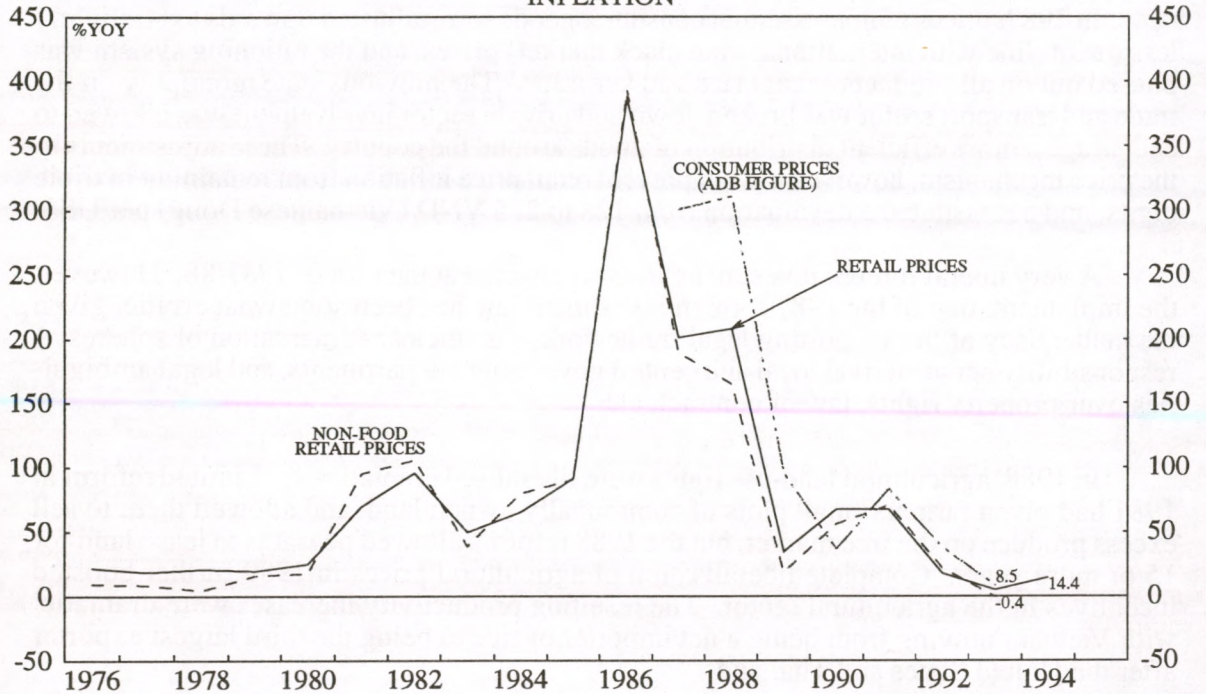
A very liberal foreign investment law was enacted at the turn of 1987/88. However, the implementation of the 1987 foreign investment law has been somewhat erratic, given the inadequacy of the supporting legal framework, e.g. unclear demarcation of spheres of responsibility between rival local and central government departments, and legal ambiguities over property rights, law of contract, etc.

In 1988, agricultural land-use rights were liberalised dramatically. Limited reform in 1981 had given farmers small plots of communally owned land, and allowed them to sell excess produce on the free market, but the 1988 reforms allowed peasants to lease land for 15 or more years. Complete liberalisation of agricultural prices in 1989 further boosted incentives in the agricultural sector. The resulting productivity increases were dramatic, with Vietnam moving from being a net importer of rice to being the third largest exporter after the United States and Thailand.

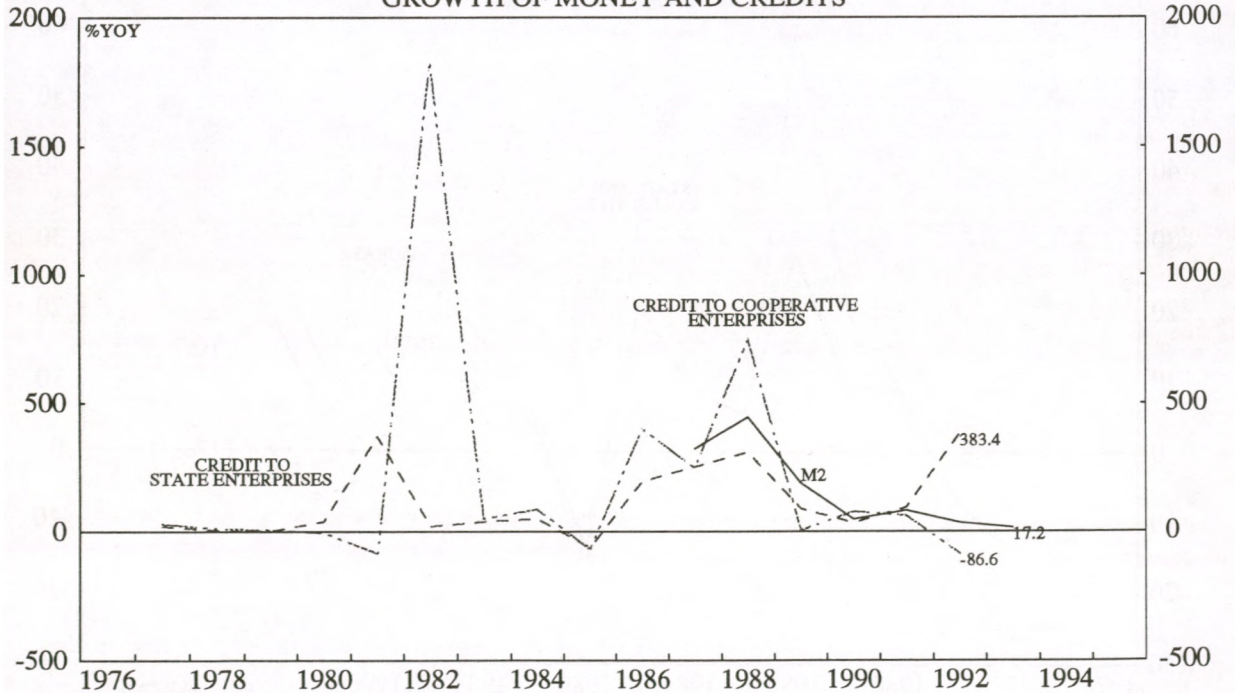
VIETNAM: CHART 2
RETAIL SALES GROWTH



VIETNAM: CHART 3
INFLATION



VIETNAM: CHART 4
GROWTH OF MONEY AND CREDITS



Another major reform in 1988 focused on the banking system. Previously, the State Bank of Vietnam (the central bank) had undertaken both central banking and commercial banking functions, and the only other banks in Vietnam were VietComBank (Bank for Foreign Trade of Vietnam), which handled trade finance and foreign currency business, and InvestBank (Bank for Investment and Development of Vietnam, which provided long-term finance for public works. The 1988 reforms devolved the commercial banking functions of the State Bank and established two new state owned commercial banks: IncomBank (Industrial and Commercial Bank) and AgriBank (Vietnam Bank for Agriculture). Further deregulation in 1990 allowed the establishment of private share-holding banks, the number of which mushroomed to 35 by the end of 1993.

Continued reform in 1988 did not, however, bring about any immediate reduction in inflation, which stayed in triple digits. The inevitable result was further devaluation to 900 VND per US\$ by the end of 1988. However, even this exchange rate was probably still overvalued and undermining the competitiveness of Vietnamese exports, and further devaluations became the norm until 1992 when the exchange rate was stabilised.

Prior to 1989 price reforms had generally been piecemeal adjustments government price regulations, and it was only with the 1989 price reforms that the government finally allowed prices of goods and services to be more market determined, and even stopped subsidising many food products and exports. The 1989 reforms also gave operational autonomy to state-owned enterprises (including army units no longer needed in Cambodia), encouraging them to follow the signals from the market mechanism and move into new areas of production.

Also, in recognition that high turnover taxes were distorting the incentive structure by cascading taxes on intermediate transactions (and was in any case difficult to collect from the non-state sector), turnover taxes were cut for many categories of goods. In 1990, a more elaborate new tax law on sale, profit and consumption taxes was promulgated.

In 1991 liberalisation efforts focused on the external trade sector. Previously, the government had had a monopoly on international trade, a large proportion of which had been barter or non-convertible currency denominated trade with other centrally planned economies. In 1991 the government dismantled its monopoly on international trade, liberalised the use of foreign currency, and established Foreign Exchange Transaction Centres (FETC) in major cities to allow intermediation of scarce foreign exchange between exporters and importers. However, a strict system of import quotas remained in place until 1993, and the individual FETCs were only replaced by a nationwide interbank foreign exchange market in late 1994.

In 1992, the government started to seriously address the legal infrastructure. A new constitution was enacted in 1992, which helped demarcate the powers and responsibilities of the various branches of government. In 1993 new laws were promulgated on 'land use rights' ('private property' still not a politically acceptable concept), bankruptcy law, and 'equitisation' of state owned enterprises ('privatisation' also still a dirty word). But while the property market has since seen dramatic price rises, 'equitisation' has so far had only limited success.

In 1994 most of the remaining controlled prices were finally liberalised. Also, in the same year, the government established several new state conglomerates through the merger of old state owned enterprises with vertical linkages, geographical proximity, or horizontal economies of scale.

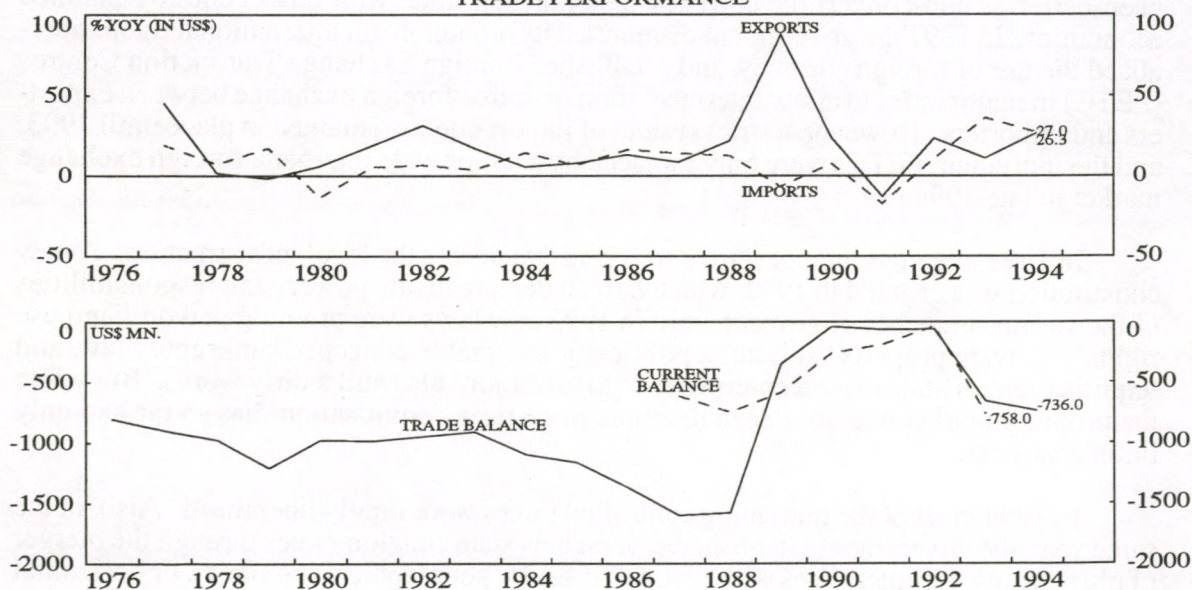
Recent macro-economic trends

The 'Doi Moi' economic reform programme was implemented in response to a crisis-situation of macro-economic imbalances, and has facilitated quite impressive progress on macro-economic stability -- in spite of a lack of international financial support until early 1994. Comprehensive analysis of this progress is complicated by shortcomings in available economic statistics; most data are available only annually, and some essential data (e.g. monetary survey) are not published at all. However, as the chart [X] shows, real GDP growth has accelerated from 5-6% in 1990-91 to over 8% in 1992-94. This acceleration in GDP growth has been driven by even faster growth in certain sectors, in particular construction and light industry, as resources have been diverted away from defence and agriculture.

The acceleration in economic growth has been accompanied by an even more impressive reduction in inflation and a stabilisation of the exchange rate. Inflation has been brought down from 200%-400% in 1986-88 to credible single digit levels for all the price indexes in 1993, although the headline retail price index subsequently climbed 14.4% in the first 11 months of 1994. This (by historical standards) low inflation environment has facilitated and been reinforced by a stabilisation of the nominal exchange rate, which has been trading in a narrow range of 10,500-11,000 Vietnamese Dong (VND) per US\$ for about three years.

The pick-up in growth and curbing of inflation have been achieved by economic policies designed to bring about fiscal, external and monetary balance. Until 1988 assistance from the former Soviet Union had allowed Vietnam to run unsustainably large fiscal and trade deficits, but the loss of this source of financing necessitated a serious adjustment to these no longer sustainable structural imbalances. The 'Doi Moi' reforms involved serious cutbacks in government expenditures in 1990 and 1991, reining in the budget deficit from 8.5% of GDP in 1989 to 2% of GDP in 1991. However, in 1992 Vietnam started to sense that international financial assistance (both aid and private sector investment) might

VIETNAM: CHART 6
TRADE PERFORMANCE



soon become available again, and fiscal policy became more expansionary widening the budget deficit to over 5% of GDP in 1993. However, much of this expenditure has gone into much needed physical infrastructure developments, and should help lay the foundations for future growth.

On the external side, the trade deficit was brought under control by a compression of imports over 1989-91. However, rapid acceleration in import growth (due to liberalisation of trade barriers and insufficiently tight credit policies) caused the trade and current accounts to deteriorate markedly from near balance in 1992 to deficits of around 8% of GDP in 1993. In order to stabilise the exchange rate, the State Bank of Vietnam (the central bank) had to sell scarce foreign exchange reserves in the second half of 1993; and in mid-1994 they announced a package of measures to increase the use of local currency in order to de-dollarise the economy and bring scarce foreign currency into the banking system. Data for 1994 suggests that the trade deficit has widened further, but it is probably being fully funded by long term capital inflows from both the official sector (mainly ADB and World Bank) and the private sector (mainly foreign direct investment from the Newly Industrialised Economies, and from non-resident Vietnamese), and not by further sales of foreign reserves.

Vietnam's banking system has been radically transformed by the Doi Moi programme of economic reforms; the commercial banking functions of the State Bank of Vietnam have been hived off into four stateowned commercial banks, more than 20 new private sector joint-stock banks have been established, and a few foreign banks have been allowed into the country (albeit only for foreign currency business). Data on the assets and liabilities of the banking system are still sketchy and inconsistent, with very moderate growth of M2 (17.2% in 1993) in the face continued rapid growth of domestic credit (over 50% in 1993), of which credit to the cooperative and private sectors nearly tripled.

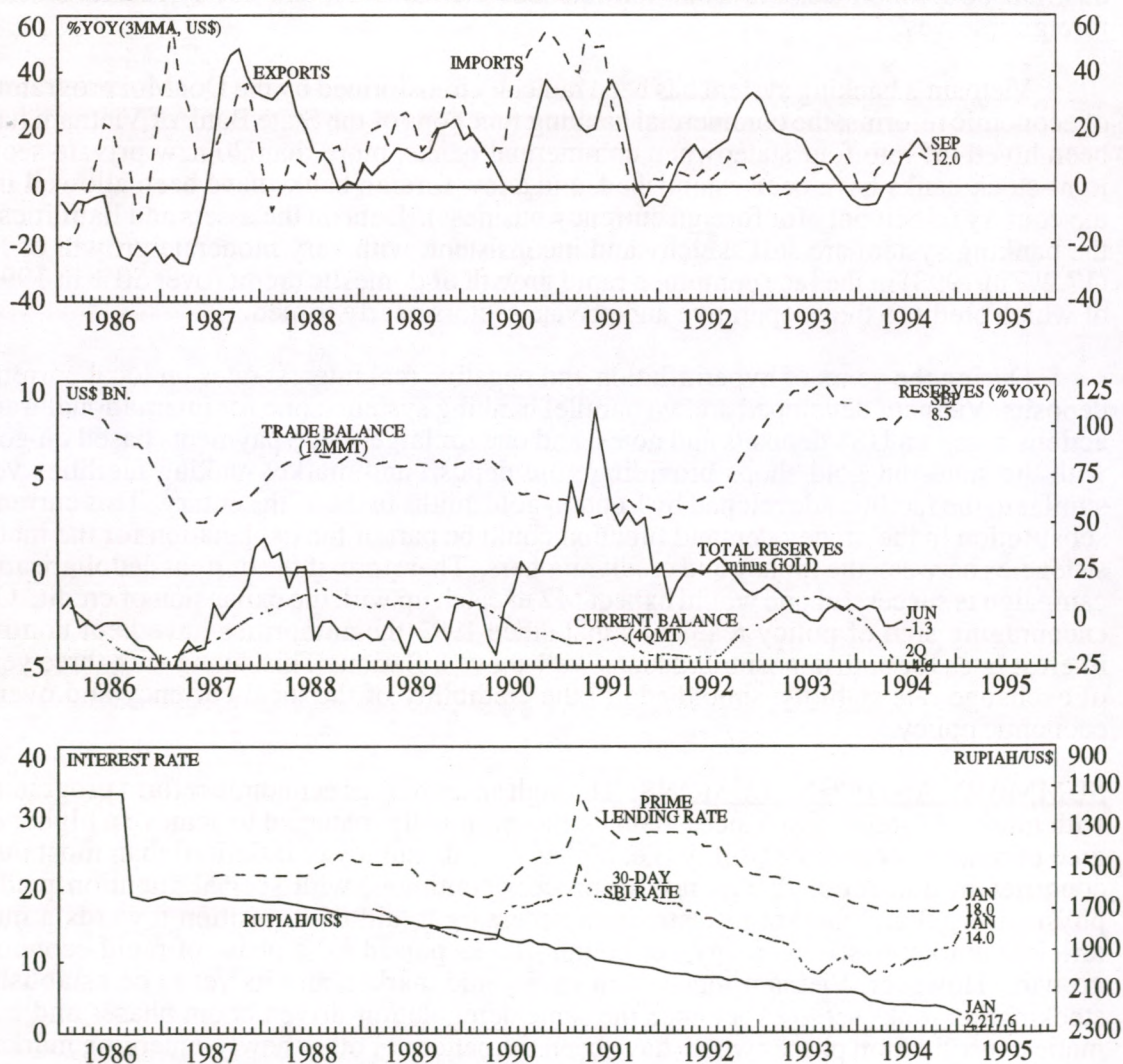
During the years of hyperinflation and negative real interest rates on local currency deposits, Vietnam developed an two parallel banking systems: one for international transactions based on US\$ deposits and notes; and one for large-value payments based on gold, with the state-run gold shops providing gold deposit and market making facilities very similar to the facilities developed by London goldsmiths in the 17th century. This currency substitution in the money demand function could be part of the explanation for the inconsistencies between the money and credit numbers. Therefore, if the current dedollarisation campaign is successful one would expect M2 to catch up with the expansion of credit. One encouraging sign of policy realism is that since 1992 the authorities have kept nominal interest rates for both deposits and loans well above inflation. This, along with three years of exchange rate stability, should add to the credibility of the local currency and overall economic policy.

SUMMARY AND CONCLUSIONS: Through an ambitious economic reform programme with minimal foreign assistance, Vietnam has eventually managed to achieve a higher degree of macro-economic stability (i.e. higher growth and lower inflation) than most other countries in transition. If this reform process continues, with special attention paid to physical, legal and market infrastructure necessary to aid the transition towards a more efficient market based economy, the country looks poised for a phase of rapid economic growth. However, Vietnam remains an embryonic market, and its yet to be established stockmarket looks set to experience the same deregulation-driven boom phases and traumatic consolidation phases which have been the pattern of other newly-emerging markets.

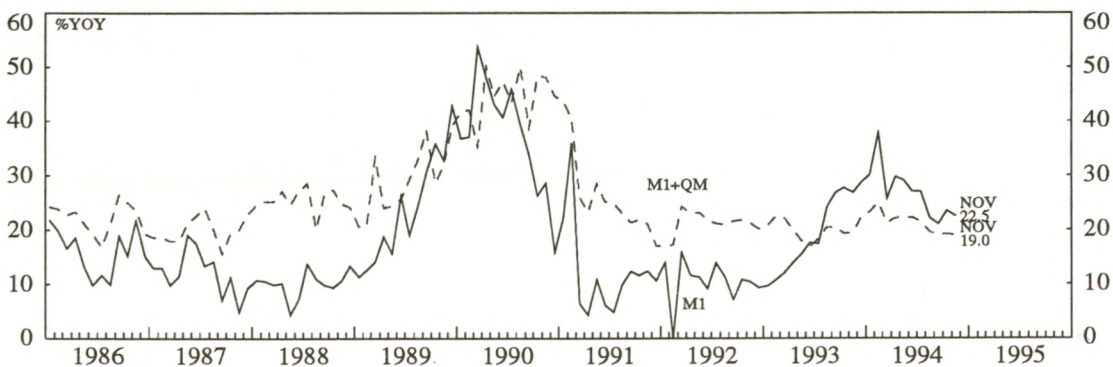
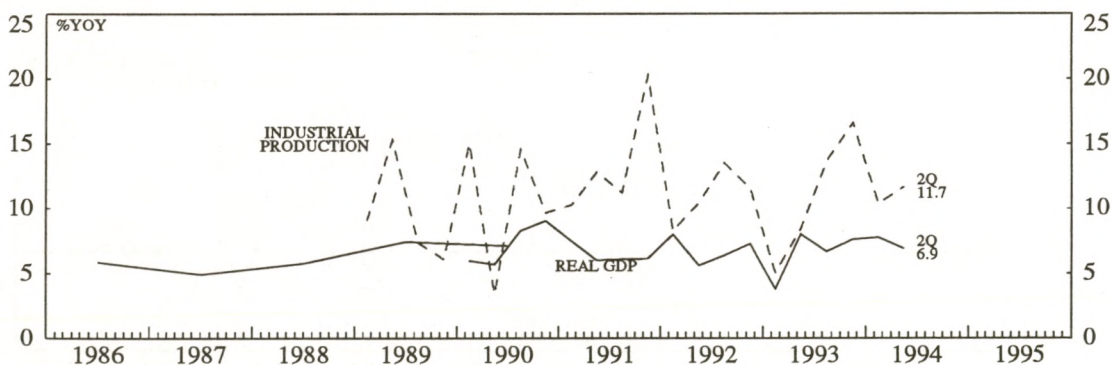
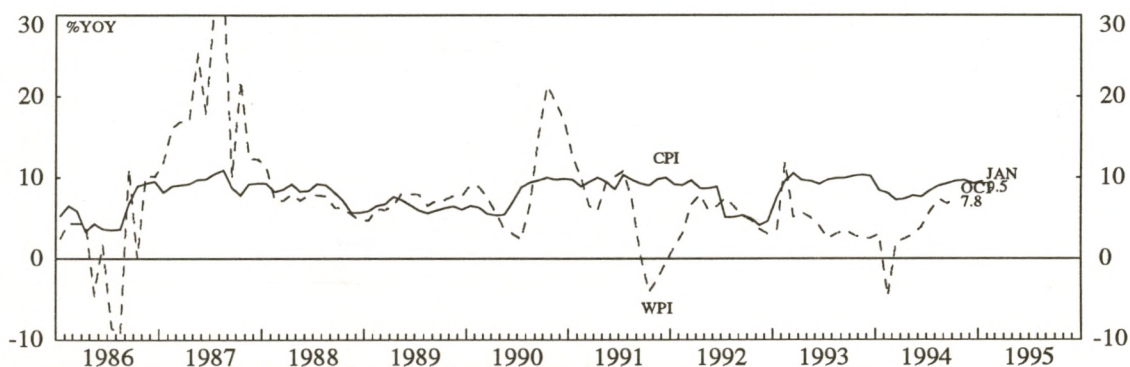
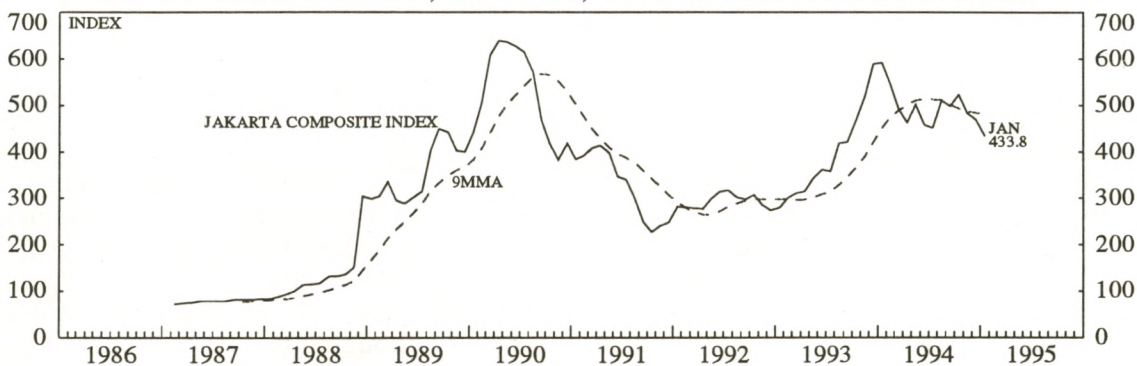
INDONESIA: TIGHTER MONEY WILL SMOOTH AND PROLONG ECONOMIC UPSWING

Tighter monetary conditions imposed partly by external factors in the aftermath of Mexico are appropriate for Indonesia's buoyant economy, where the authorities were getting increasingly concerned about CPI inflation hitting the 10% threshold of political acceptability. The authorities are still pursuing a policy of gradual (3-4% p.a.) nominal IR/US\$ exchange rate depreciation to achieve a fairly stable and competitive real effective exchange rate. The rise in interest rates will moderate (but not eliminate) and thereby hopefully prolong the current upswing in economic activity. Given that the monetary excesses of 1993/94 were somewhat smaller than those of 1989/90, it seems likely that any necessary monetary tightening and consequent impact on asset prices will be far less severe. However, concerns about the volume of potential new share issues, political succession and probable further increases in US and local interest rates still detract from an otherwise quite positive economic outlook of a prolonged and moderately strong earnings cycle.

INDONESIA: MONEY MARKET AND BALANCE OF PAYMENTS



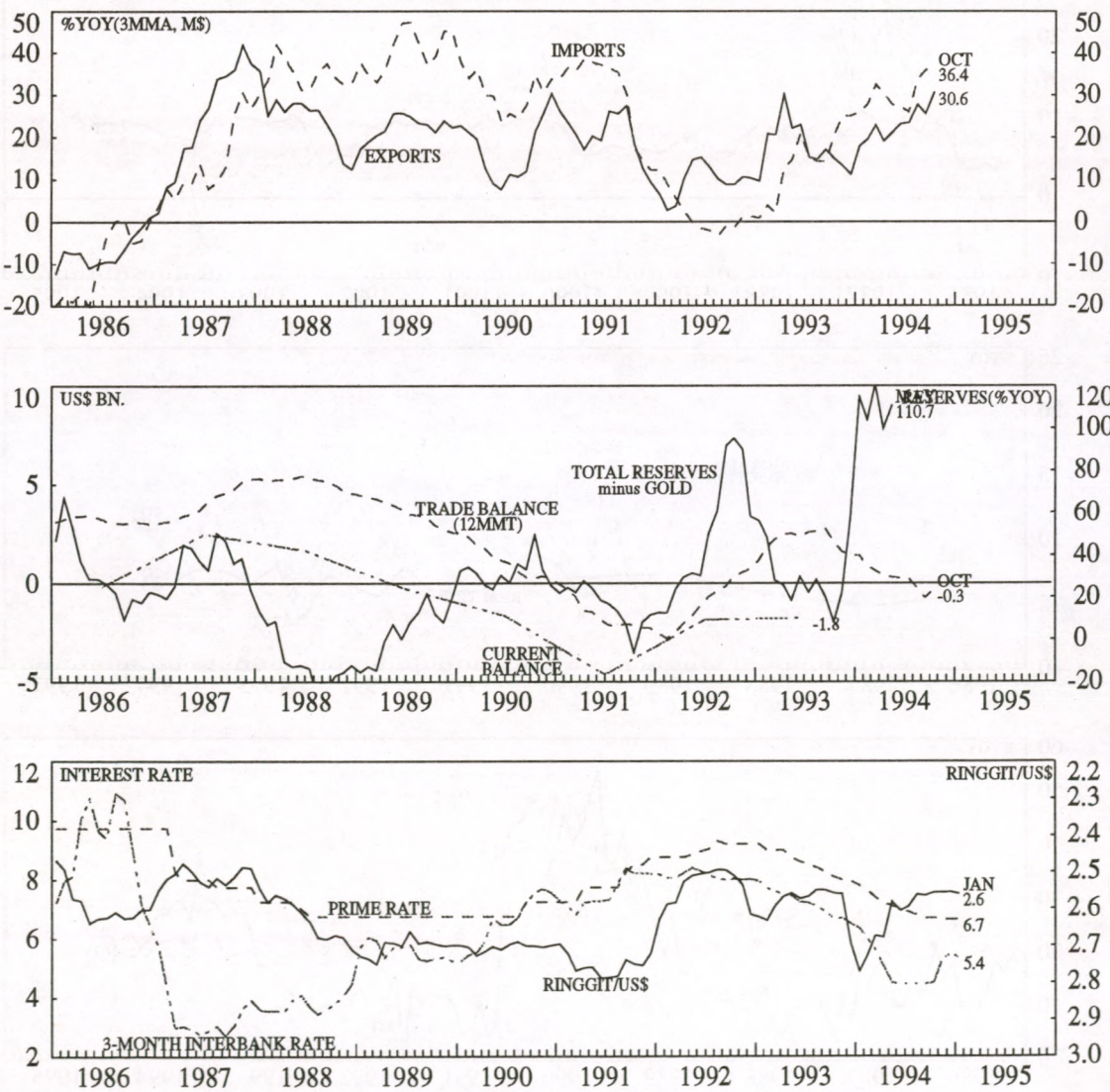
INDONESIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



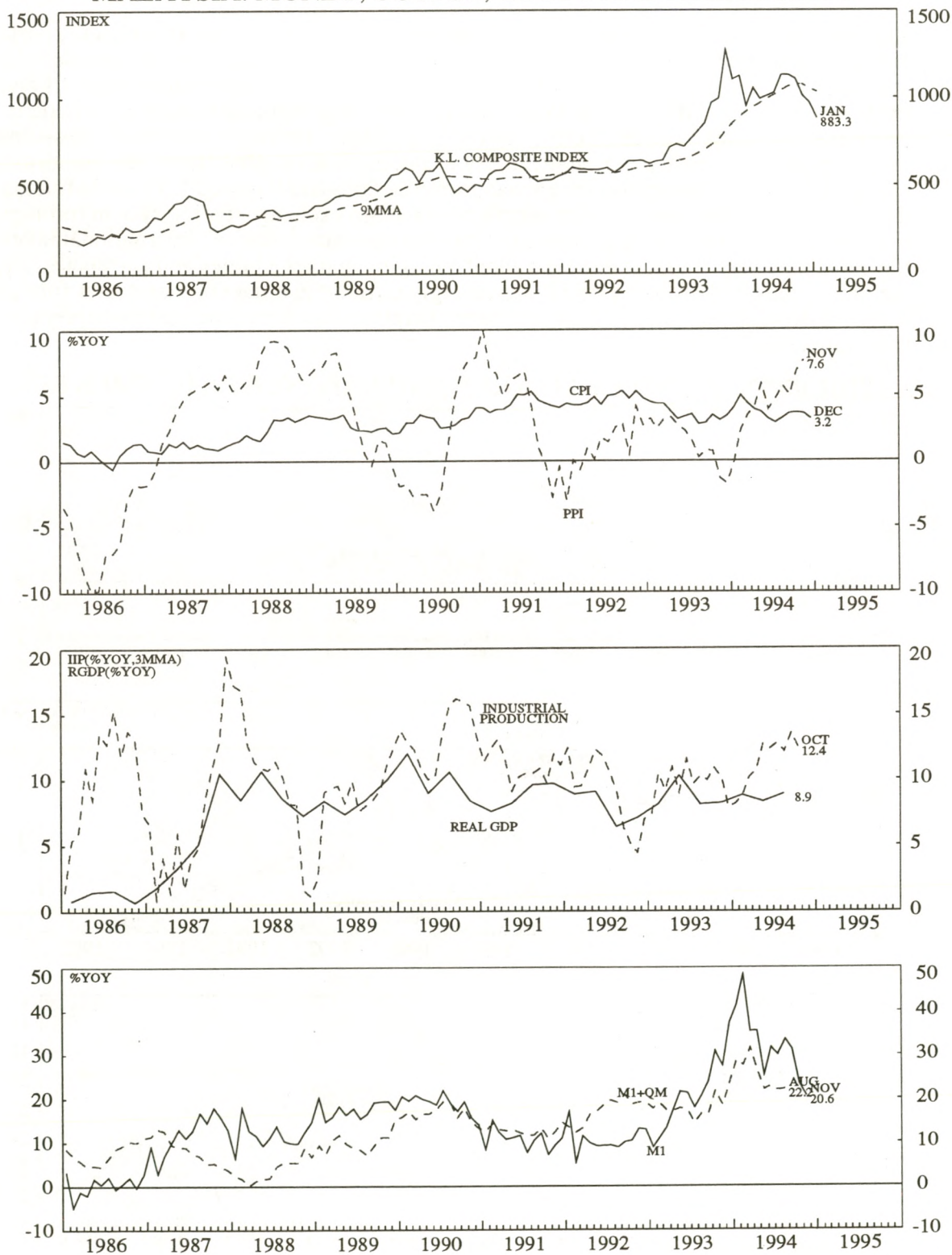
MALAYSIA: MONETARY TIGHTENING TO FOLLOW UPSWING IN CREDIT

The main inconsistency in economic policy in 1992-93 (of keeping the exchange rate undervalued while keeping local interest rates above international levels) has now largely disappeared, but it has generated a surge in monetary growth in 1994 which will continue to feed through to higher aggregate demand this year. So far the excess liquidity in the banking system has meant that domestic interest rates have remained low in both international and real terms. However, monetary authority will likely tighten later this year following stronger credit growth, further deterioration in the trade and current account balances and the prospect of an acceleration in the inflation rate. The outlook for the RM/US\$ exchange rate is for a strengthening later this year although it could well weaken in the meantime given the trend in the trade account.

MALAYSIA: MONEY MARKET AND BALANCE OF PAYMENTS



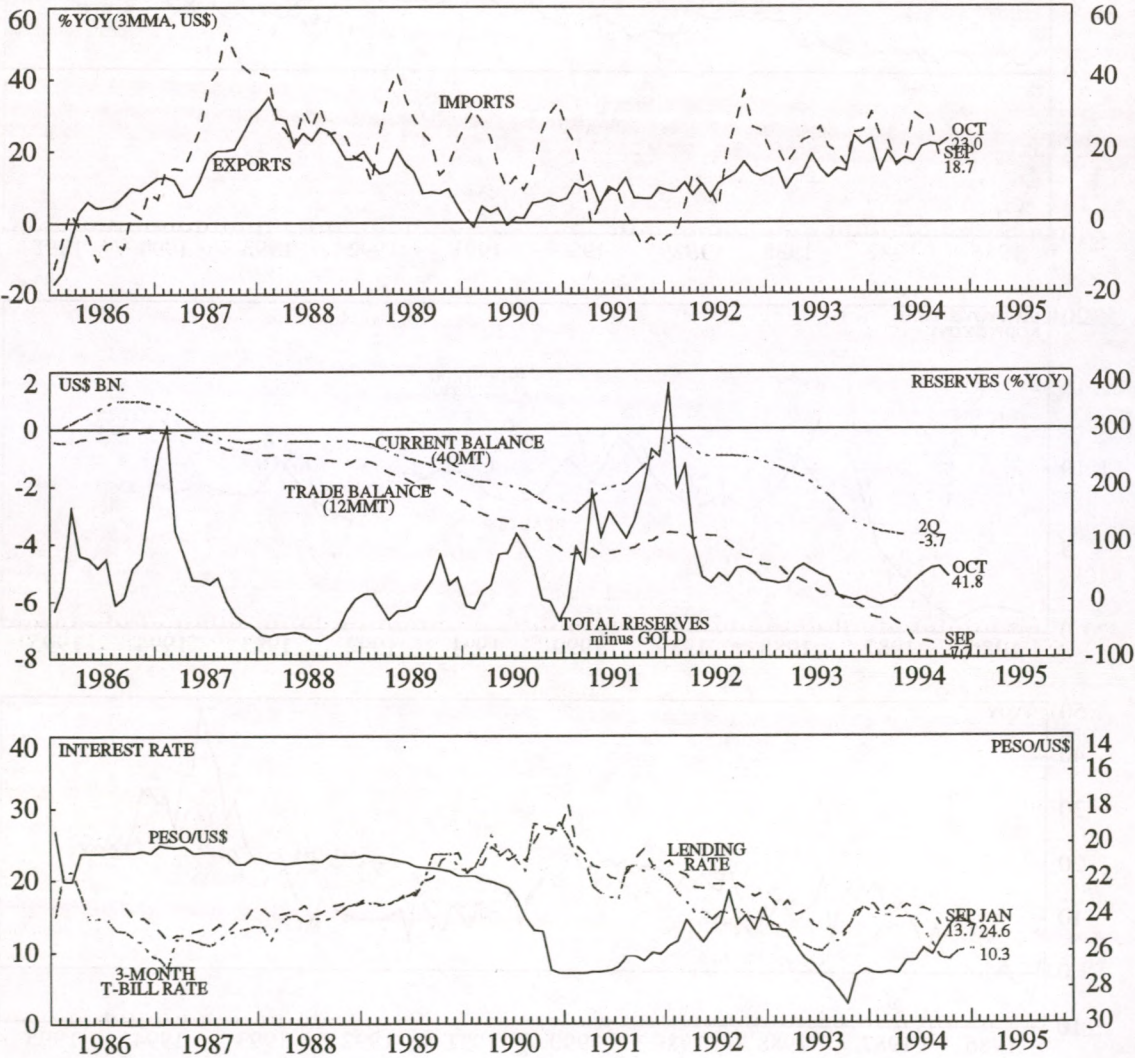
MALAYSIA: MONEY, OUTPUT, GOODS AND ASSET PRICES



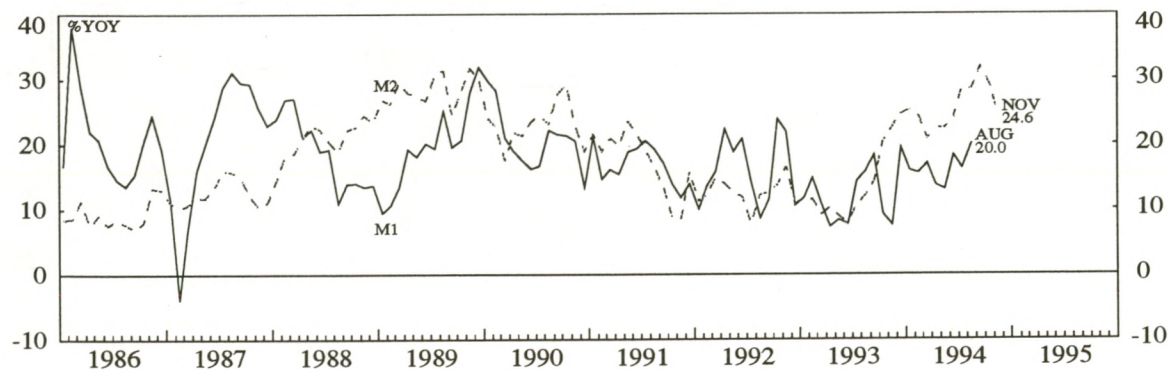
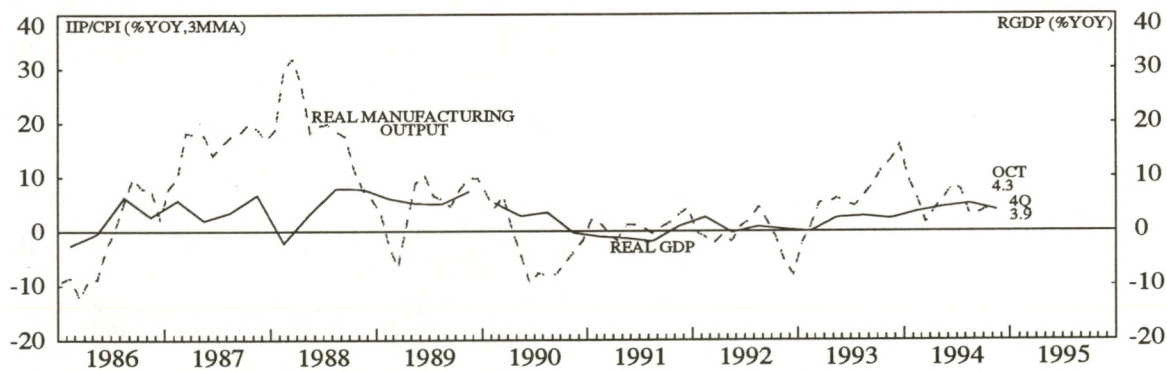
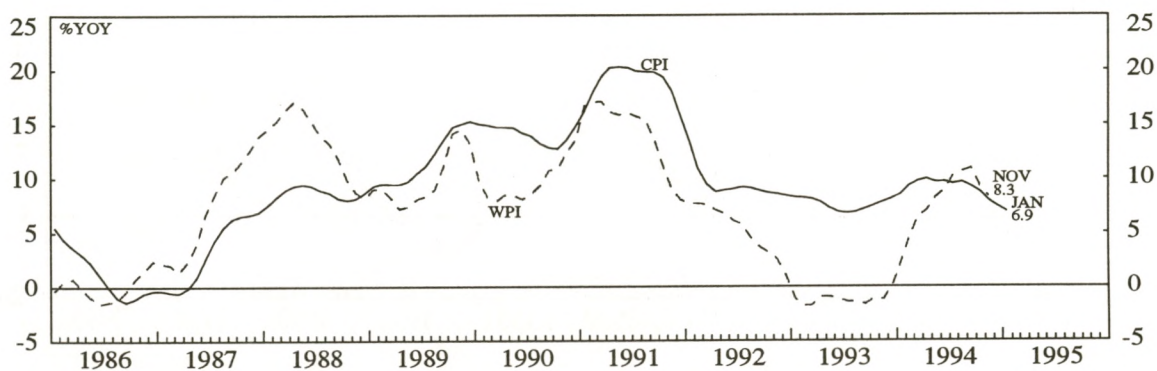
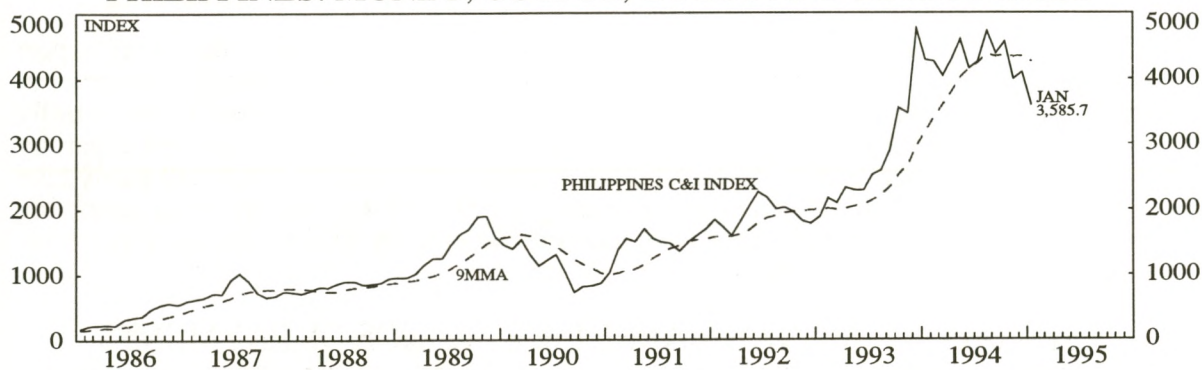
PHILIPPINES: EASY FOREIGN MONEY UNLIKELY TO LAST

The recovery in activity in 1993 and 1994 had been led by strong investment and exports, and accompanied by even stronger imports, widening trade and current account deficits, and largescale capital inflows -- as evidenced by stable, and more recently rising, foreign exchange reserves and a stronger Peso. Along with lower statutory reserve requirements, this has boosted the growth of credit and money supply, fuelling inflationary pressures. Increasingly concerned about vulnerability to international capital flows, the authorities clamped down on forward foreign exchange transactions and imposed 1.5% daily fluctuation limits on the spot rate in their computerised foreign exchange trading system (prompting suspension of peso trading during the January currency debacle). International investors have now become more cautious about emerging market equities and currencies, and the Philippines will probably find it increasingly difficult to attract private sector foreign capital inflows unless interest rates rise more sharply and/or the exchange rate depreciates to a more attractive level.

PHILIPPINES: MONEY MARKET AND BALANCE OF PAYMENTS



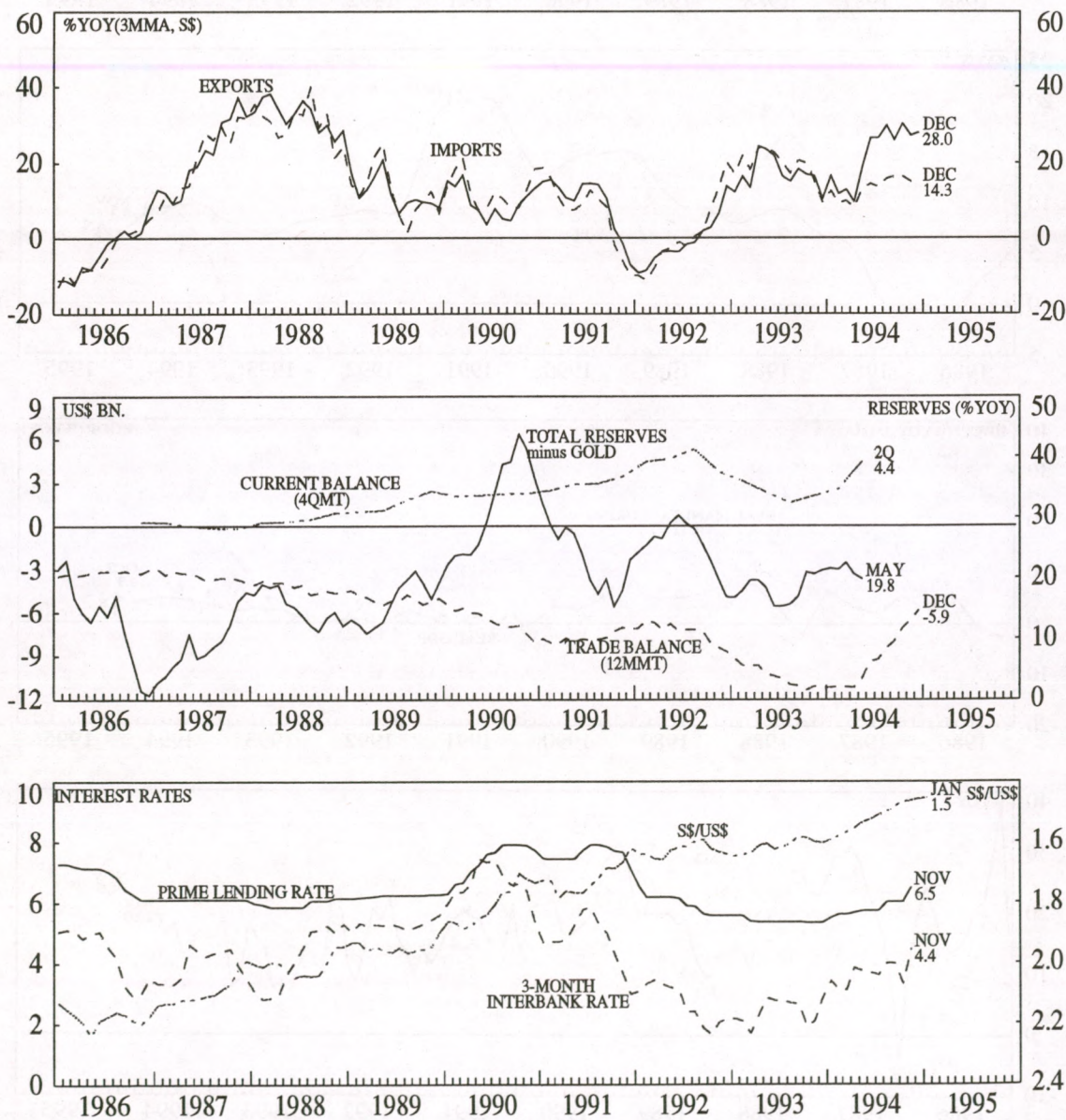
PHILIPPINES: MONEY, OUTPUT, GOODS AND ASSET PRICES



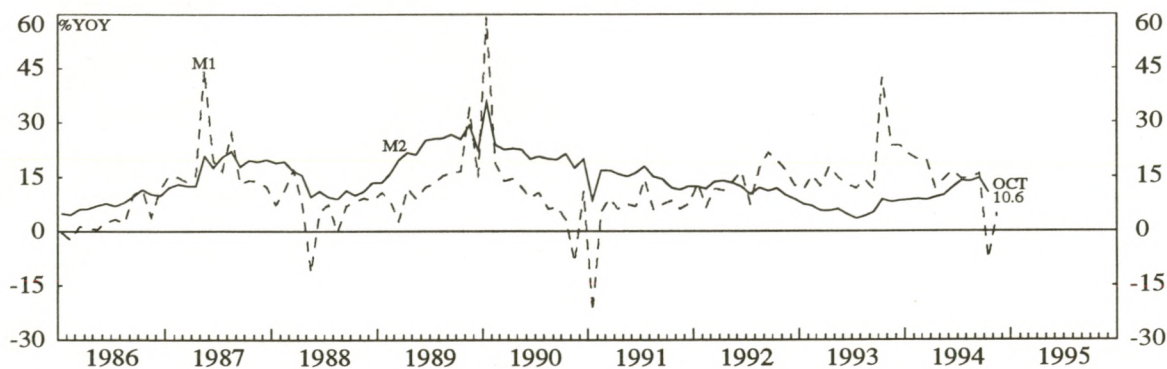
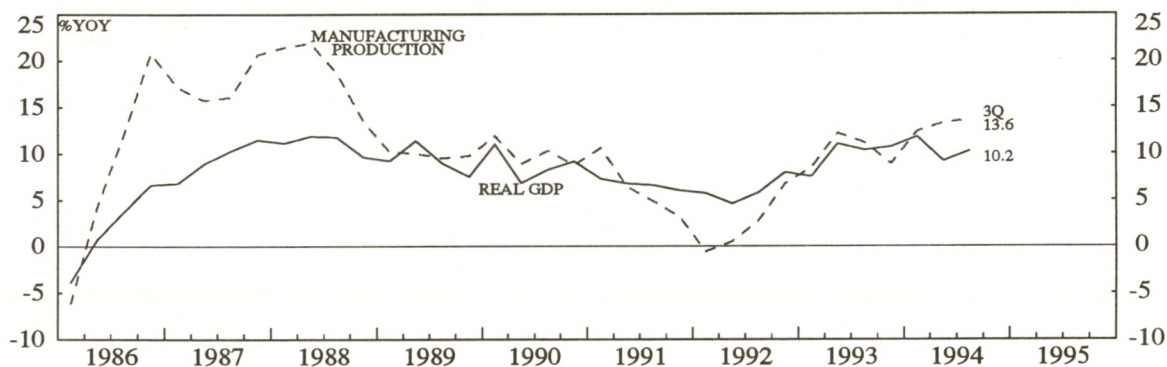
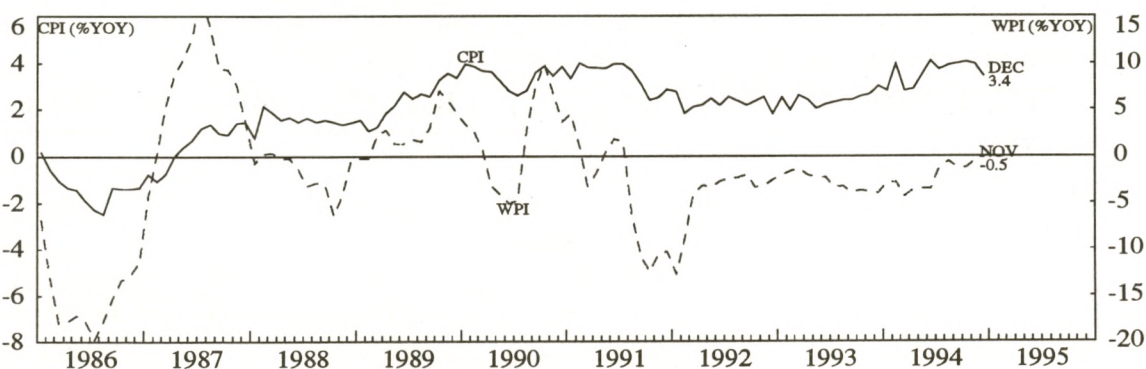
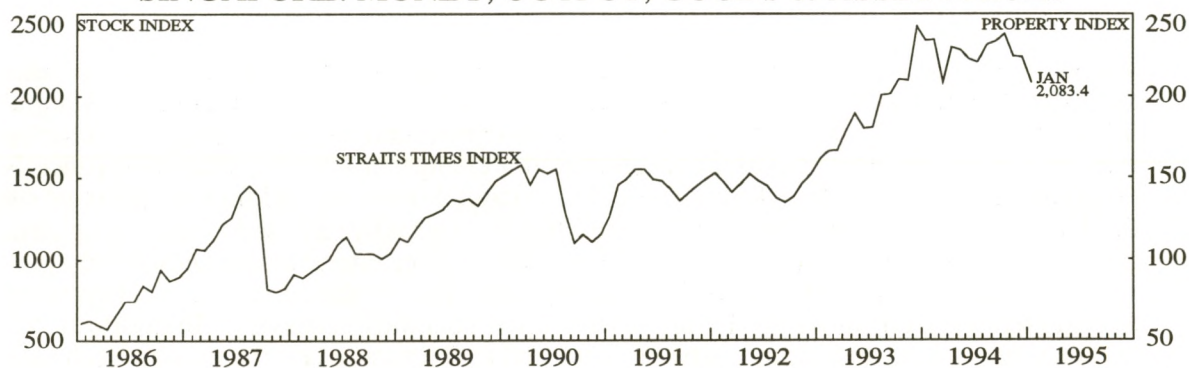
SINGAPORE: EXPANDING CREDIT SPELLS TIGHTER MONEY

The economy is currently growing at a rapid rate led by a continuation in the strong export performance (even in S\$ terms). Notwithstanding the exchange rate appreciation and rising local short term interest rates in 1994, monetary policy has essentially been mildly stimulative. With further acceleration in deposits and credit in 1995 (stimulated in part by the expansion in private home ownership and consumer credit) the MAS will likely take more noticeable steps to tighten monetary policy in 1995. This would involve a narrowing in the differential between local and US\$ short rates along with S\$/US\$ currency appreciation similar in magnitude to that experienced last year.

SINGAPORE: MONEY MARKET & BALANCE OF PAYMENTS



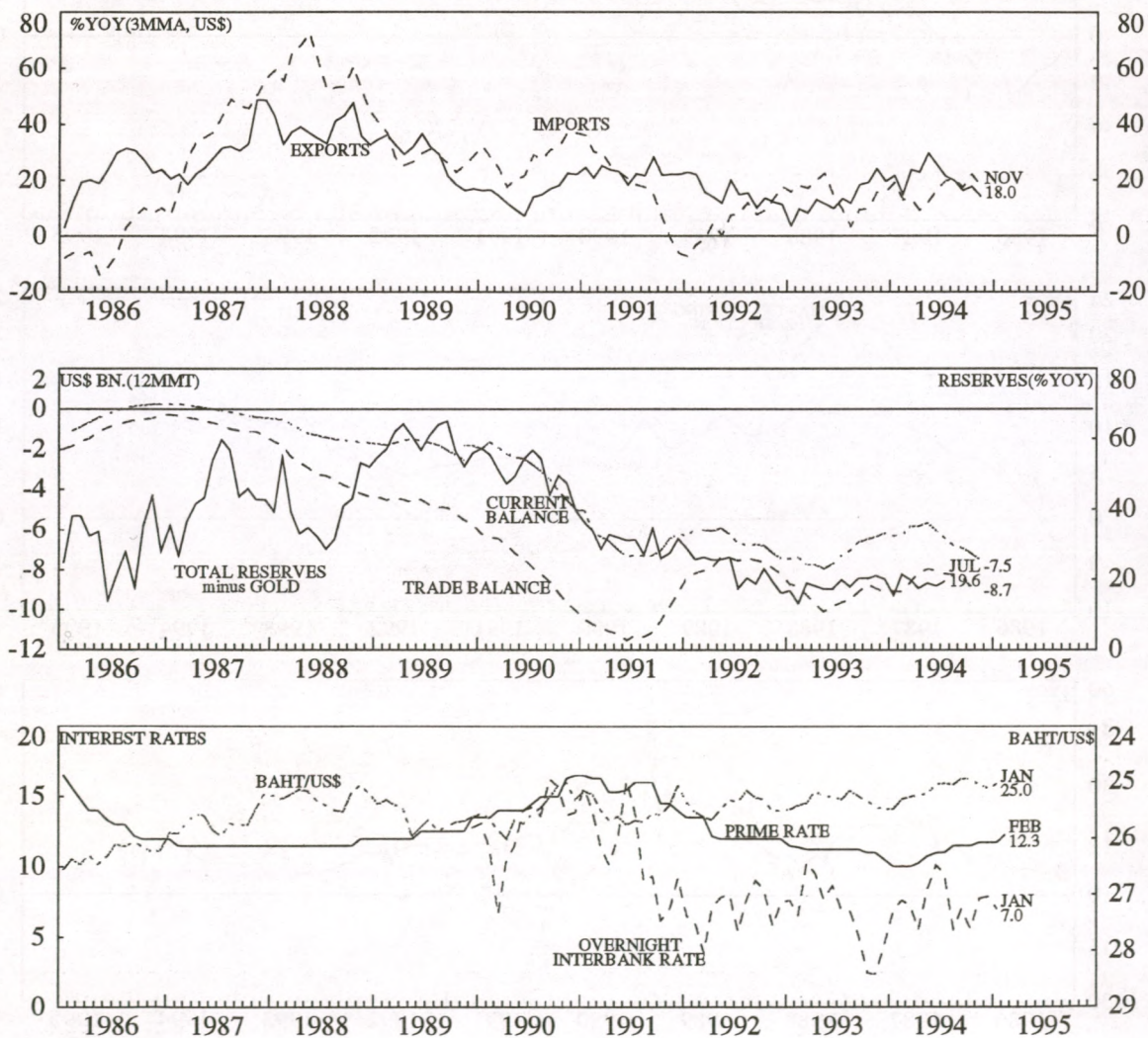
SINGAPORE: MONEY, OUTPUT, GOODS & ASSET PRICES



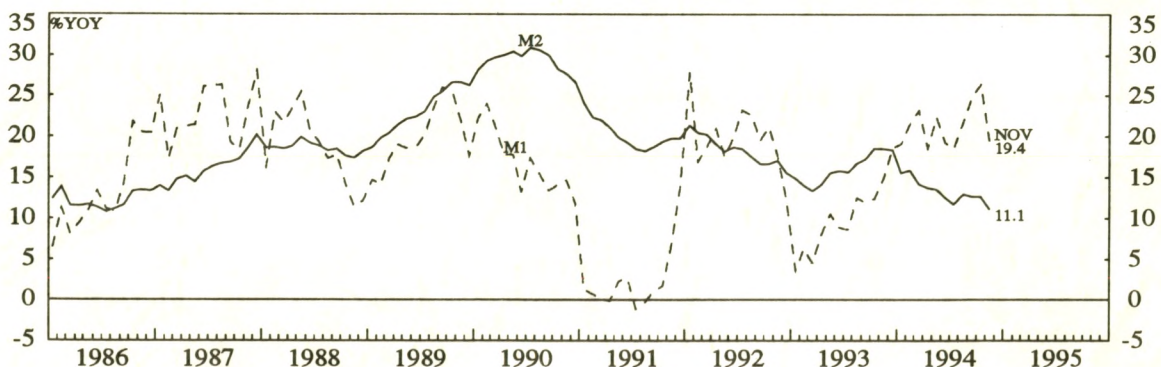
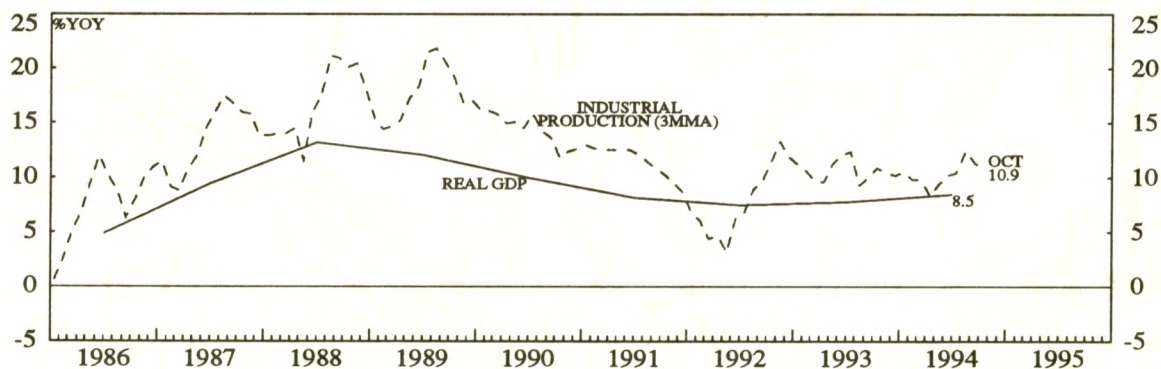
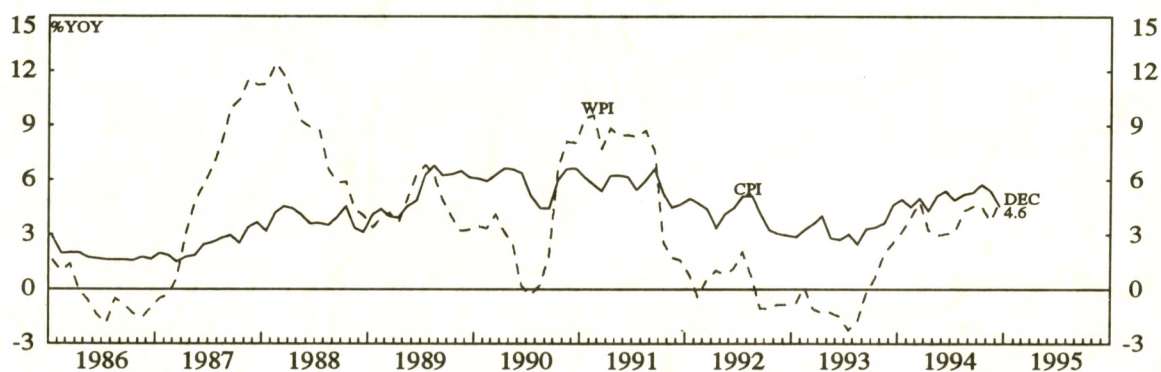
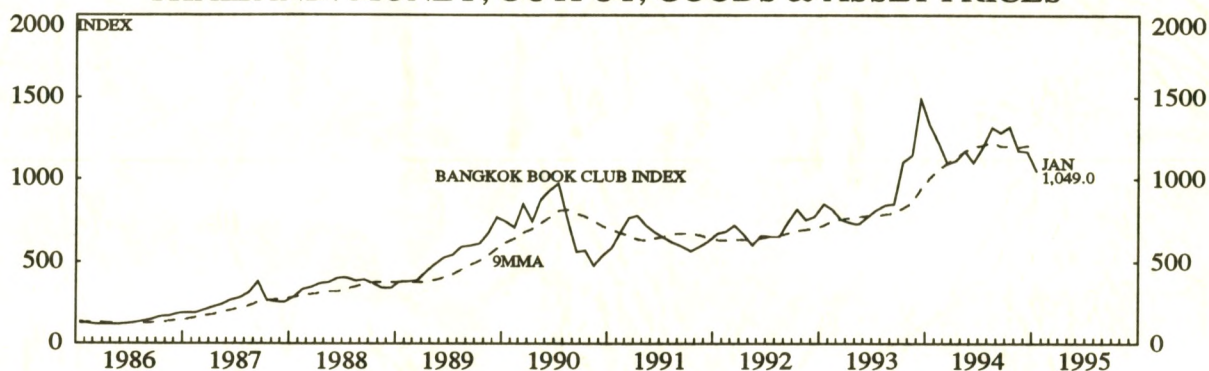
THAILAND: A VERY TIMELY EXTERNALLY IMPOSED TIGHTENING

The economy is growing strongly, and the authorities have been grappling for some time with the dilemma of how to raise domestic interest rates without attracting substantial difficult-to-sterilise short-term capital inflows while maintain the basket-pegged exchange rate. However, Mexico's devaluation prompted a change in investor sentiment towards emerging markets including Thailand and led to capital outflows and upward pressure on the Thai-US interest rate differential -- a very timely externally imposed monetary tightening for Thailand's buoyant economy. The resulting higher interest rates should help prevent Thailand's economy from overheating and thereby allow the current cyclical upswing to be extended well into 1996 before a slowdown becomes necessary. In addition, the higher interest rates and capital outflows have reduced pressures on the current exchange rate policy framework and the temptations for the authorities to make greater use of regulatory and supervisory tools to affect monetary and credit conditions (another possible solution to Thailand's policy dilemma discussed in the last AMM).

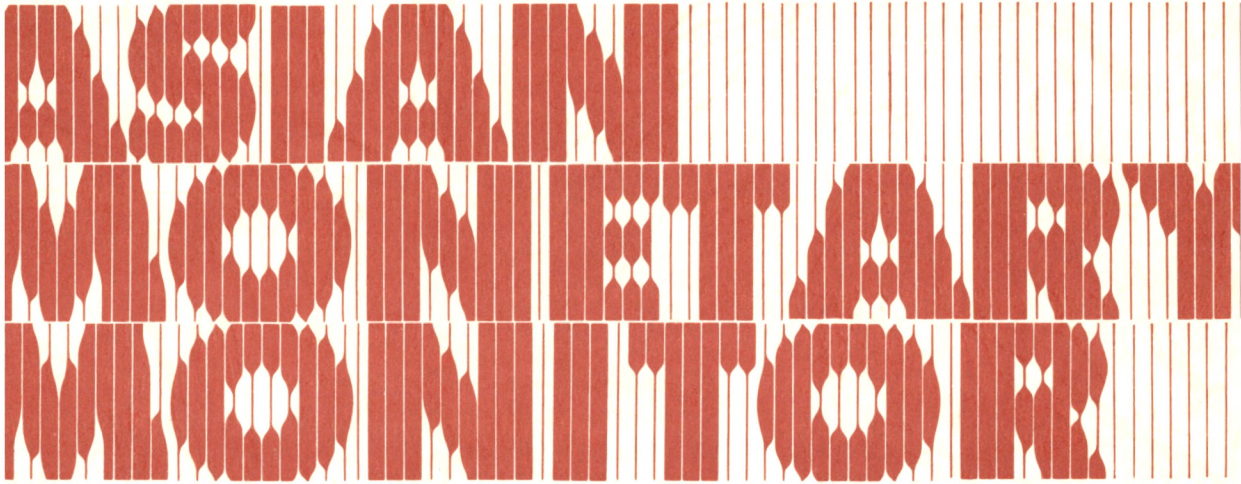
THAILAND: MONEY MARKET AND BALANCE OF PAYMENTS



THAILAND: MONEY, OUTPUT, GOODS & ASSET PRICES







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HONG KONG THE DEBATE ON THE OPTIMUM MONETARY SYSTEM

Introduction

In recent weeks there has been an active debate in Hong Kong on the merits and demerits of the fixed exchange rate system introduced in October 1983 and operated -- with slight modifications -- since that time. In this debate the impact of Hong Kong's monetary system on asset price inflation has been at centre stage. In previous debates on the monetary system the key issues have been: (1) whether Hong Kong's fixed exchange rate caused economic growth performance to be more variable than otherwise, (2) whether CPI inflation was avoidable, and its relationship to the exchange rate and traded goods prices, and (3) whether income distribution was adversely affected by the choice of monetary regime. As these latter three topics have been covered in varying degrees in past issues of AMM, in this article we focus mainly on the question of asset price inflation (or deflation) and its relation to the monetary regime.

Three Available Mechanisms

In the modern world of fiat (i.e., paper) currencies, there are only three workable mechanisms available for managing monetary systems. Countries (or territories) can either (1) have a central bank and manage the money supply, or (2) have a central bank and peg or manage their currency, or (3) have a currency board and fix their currency permanently to some other currency. All these systems have both advantages and disadvantages. None of them is without drawbacks, and it is always an open question as to whether it is desirable to change from one system to another. There is no necessity for a country to choose one system and maintain it forever, but it is unquestionably better for credibility and for economic stability to choose one system and stick with it as long as economic conditions permit.

No country has successfully managed its economy solely by targeting interest rates. Hong Kong tried to do this in the period 1974-83 and it was a disaster. The only effective monetary instrument was the interest rate agreement amongst the banks, and the influence the monetary authorities had on those rates through moral suasion. The system produced wide swings in money and credit (between 0 and 40% year-on-year), which also generated huge booms and busts in the stock market and in real estate, together with double digit inflation in the early 1980s. In addition, since the currency was floating and the government did not have the means to stabilise it through intervention, currency instability added to Hong Kong's misfortunes during those years. Nobody with any memory or knowledge of that period could seriously advocate a return to that system.

Money Supply Control Systems

The primary advantage of the first system (money supply control) is that it enables a government or central bank to control the rate of inflation. The main disadvantage is that such systems are discretionary, i.e., they depend on allowing free rein to a few individuals (who are usually not elected). In addition, it is difficult to ascertain and maintain the right

rate of money growth -- especially in periods of financial deregulation or other rapid economic changes. Few countries have succeeded in this policy for a prolonged period. Among those that have tried, Germany and (at least some of the time) Switzerland, have done pretty well over the past 20 years. However, even they have not avoided the booms and busts of the normal business cycle, nor have they avoided the associated asset bubbles. Japan also followed this kind of policy between 1974 and 1985, and it worked extremely well, but in the end the Japanese were blown off course by demands from the US to appreciate the yen, lower interest rates, and allow money and credit to grow faster. This led to the asset bubble of the late 1980s, and I think it is reasonable to argue that Japan is still trying to solve the problems created by that episode of derailment.

A necessary counterpart of controlling the money supply is that the exchange rate should be freely floating. If the exchange rate is not freely floating, i.e., if the monetary authority intervenes actively to adjust the level of the exchange rate, then there will inevitably be an impact on the money supply which is not compatible with the money supply growth target. Theoretically, foreign exchange intervention can be offset in the domestic money markets by open market operations or other similar techniques, but these operations will fully or partially extinguish the effect on interest rates of the original intervention in the foreign exchange market. Hence foreign exchange intervention either undermines the money supply growth strategy directly or shifts the emphasis to maintaining a given level of interest rates, which over time will undermine the strategy indirectly. In Hong Kong's circumstances a freely floating exchange rate would not only be extremely hazardous, but, in addition, the problem of setting and achieving an appropriate money supply growth target would be highly problematical for an economy which has so much of its activity externally determined.

Pegged or Managed Currency Systems

Second, there are the countries -- the vast majority -- which have tried to manage their economies by means of a rigid or variable currency pegs, i.e., maintaining an exchange rate which is either fixed to another currency at a single value (or within a very narrow band), or allowed to move along some predetermined path (e.g., a crawling peg as in Indonesia or as in Mexico before December 20, 1994). The main advantage of pegged rate systems is that by relying on an external anchor for regulating the balance of payments and hence the rate of growth of money and credit, the inflation rate will fluctuate only within a limited range on either side of the inflation rate of the country to which it is pegged. (Some qualifications apply in respect of comparisons of non-traded goods prices, especially when productivity growth rates in the two countries concerned differ significantly.)

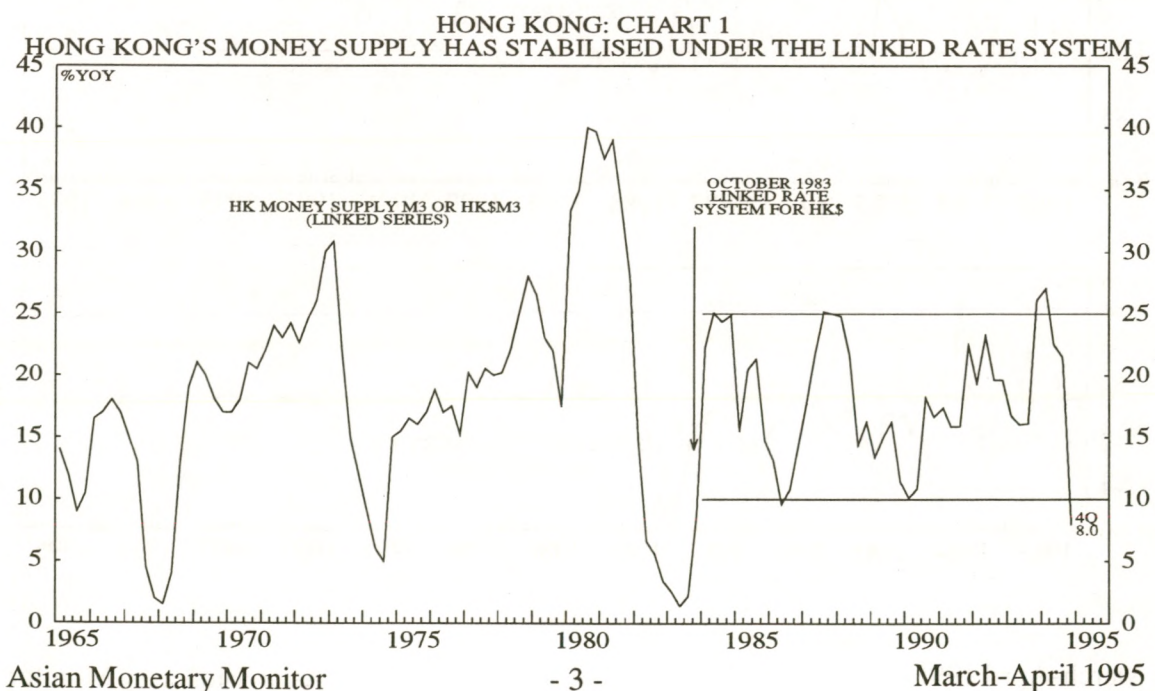
The main disadvantage of this system is that the central bank in the pegged rate country is usually free to continue to intervene in the domestic money markets, thus creating money and credit which may not be compatible with equilibrium in the balance of payments. This is the major reason why the most extensive systems of pegged exchange rates, e.g., the Bretton Woods System and the ERM, have all broken down. It is also one reason why Mexico's crawling peg system collapsed. In 1994 Mexico expanded the money supply at a rate (22% p.a.) which was incompatible with maintaining the prevailing Peso/US dollar exchange rate.

Again, pegged or managed currency systems have not been immune to business cycle fluctuations or booms and busts, or asset bubbles. Perhaps the most striking examples in Asia are the asset bubbles that occurred in equities and real estate in Korea and Taiwan in the late 1980s. A major problem in each case was to try to manage the currency upwards at a rate which would precisely offset the balance of payments surplus and hence would

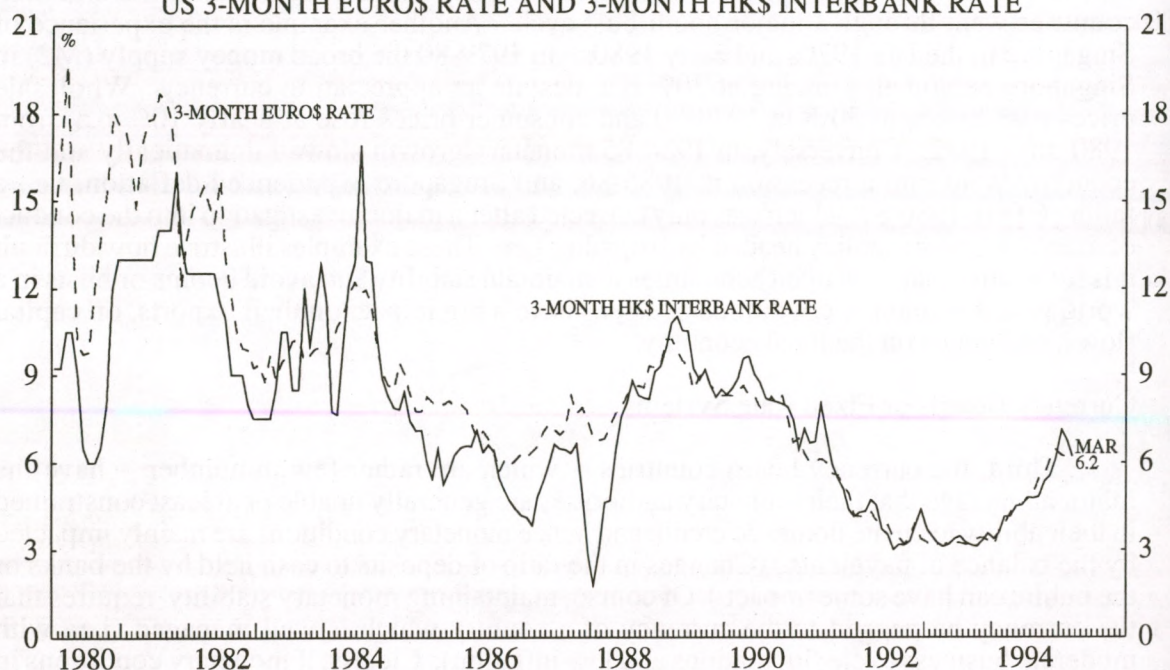
prevent money and credit from growing too fast. Since both countries had strong export lobbies, there was fierce opposition to rapid currency appreciation, and in the end both countries went through a major boom-bust cycle. Another example is the experience of Singapore in the late 1970s and early 1980s. In 1979-80 the broad money supply (M2) in Singapore exploded, growing at 30% p.a. despite an appreciating currency. Wholesale prices rose by about 30% in 1979-80 and consumer prices rose at nearly 10% p.a. from 1980 until 1982. Conversely, in 1984-85 monetary growth slowed dramatically and the economy went into a recession in 1985-86, and Singapore experienced deflation, i.e., a falling CPI in 1986-87, which was only corrected after a major investigation into the conduct of macro-economic policy headed by Brigadier Lee. These examples illustrate how difficult it is for small, relatively open economies to maintain stability and avoid booms or busts in a world where economic conditions overseas have a big impact on their exports, on capital flows, and hence on the local economy.

Currency Boards or Fixed Rate Systems

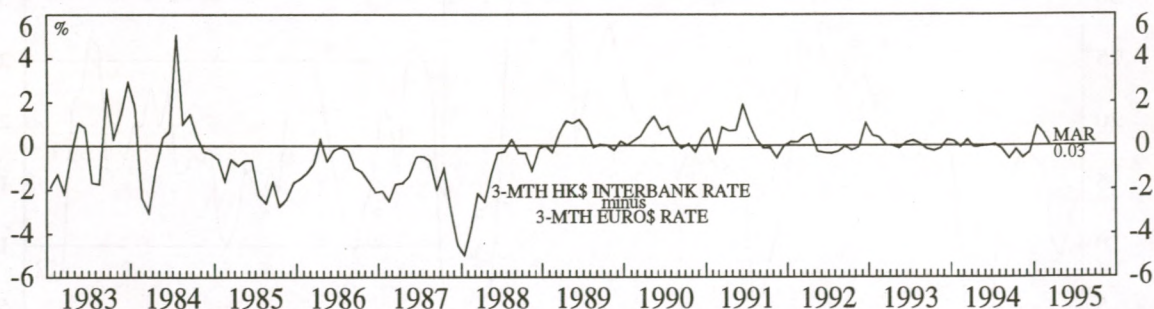
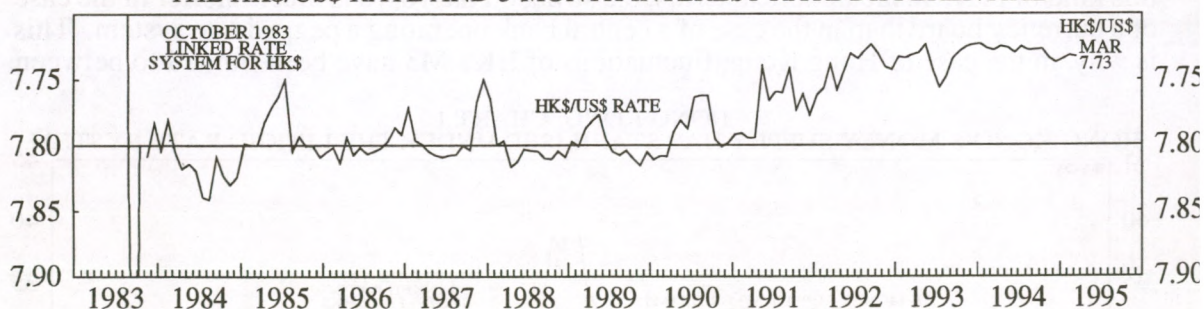
Third, the currency board countries -- which are rather few in number -- have the major advantage that their monetary authorities are generally unable or at least constrained in their ability to create domestic credit, and hence monetary conditions are mainly impacted by the balance of payments. (Changes in the ratio of deposits to cash held by the banks or the public can have some impact.) Of course, maintaining monetary stability requires that the currency be pegged to the currency of a country which is well managed (i.e., with moderate business cycle fluctuations and low inflation). Clearly, if monetary conditions in the anchor-country are too easy, they will be reflected in the economy of the currency board country. But, whereas in a pegged currency system with a central bank monetary conditions can be substantially easier or substantially tighter than conditions in the economy of the anchor currency (on account of the domestic credit-creating or credit-extinguishing capacity of the central bank), in a currency board system there is relatively little scope for this kind of play. In metaphorical terms, the string on the yo-yo is much shorter in the case of a currency board than in the case of a central bank operating a pegged rate system. This is why, in the case of Hong Kong, fluctuations of HK\$ M3 have been limited to between



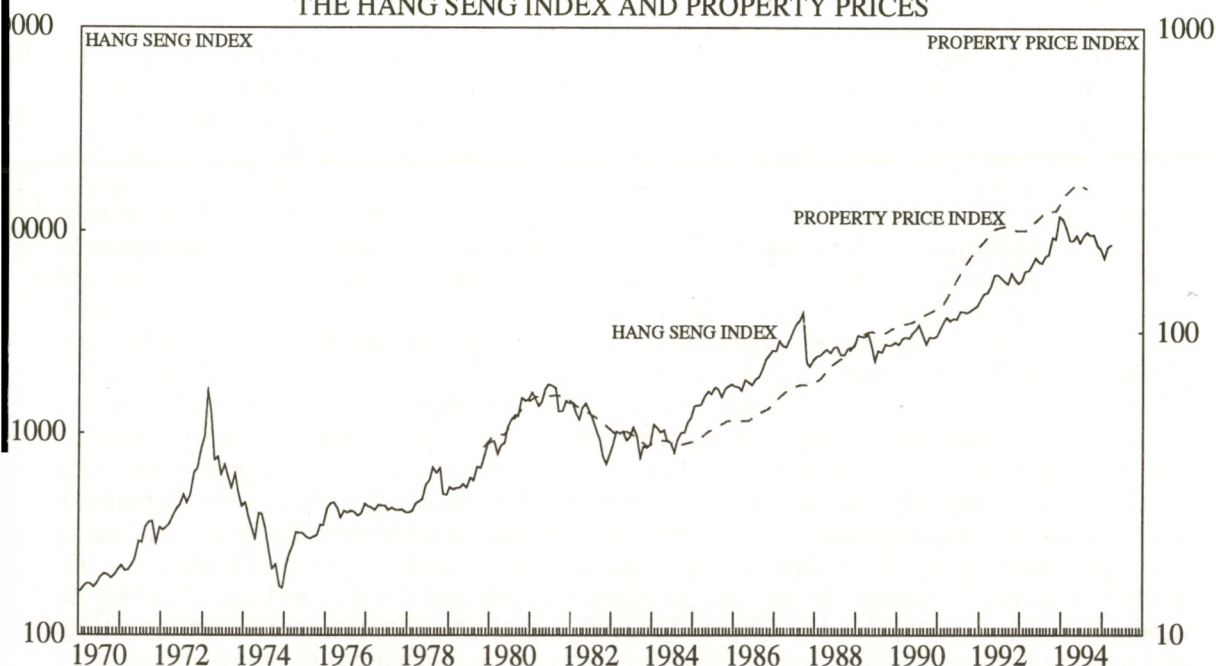
HONG KONG: CHART 2
US 3-MONTH EURO\$ RATE AND 3-MONTH HK\$ INTERBANK RATE



HONGKONG: CHART 3
THE HK\$/US\$ RATE AND 3-MONTH INTEREST RATE DIFFERENTIAL



HONG KONG: CHART 4
THE HANG SENG INDEX AND PROPERTY PRICES



about 10% and 25% under the linked rate system since 1983 compared with 0-40% between 1974 and 1983. It also explains why Argentina, which has a monetary system very similar to the classic currency board system, had a monetary growth rate (for M3) in 1994 of only 10-11% compared to 22-23% for Mexico. (Subsequently Argentina's M3 has slowed down to 1.8%, and may fall even more.)

CONCLUSION: To conclude, no monetary system is perfect. Those who advocate abandoning Hong Kong's currency board system must propose a concrete, workable alternative, but they must bear in mind that even those Asian countries which have managed their currencies (e.g., Singapore, Taiwan, or Korea) have not escaped booms and busts. Moreover, these three countries have all maintained exchange controls in some degree. Even Singapore curtails the internationalisation of its currency by means of limits on banks' dealings with offshore counterparties and through requiring MAS approval for S\$ derivatives and forward transactions. (This is usually dependent on an underlying trade transaction.) More generally the authorities there heavily influence the flow of savings in the economy and hence the net inflows or outflows of capital.

In the face of unknown political and economic shocks from China in the future, it would be unwise, in my view, for Hong Kong to risk moving to a more variable exchange rate system. Moreover, since Hong Kong probably has the most open economy in the world, it would be extremely difficult at the best of times for the HKMA to judge the right level of the exchange rate or the optimum growth rate of the quantity of money so as to offset exactly all external disturbances -- much more difficult than for the generally less "open" and more managed economies of Singapore, Taiwan or Korea. Hong Kong's version of the currency board may not be perfect, but as Churchill said about democracy, it is the worst system, except all those others that have been tried from time to time.

KOREA INVESTMENT-LED OVERHEATING

Although Korea's economic upswing since early 1993 has been impressive, there are some major differences compared with previous recoveries which cast doubt on the sustainability of the present upswing. Previous economic upswings have generally followed the pattern of a classic Asian export-led growth cycle: an export boom leading to an improvement in the trade balance, boosting both corporate earnings and money supply, thus stimulating investment and related imports a few quarters later in the cycle, with subsequent deterioration in the trade balance as export markets falter or domestic demand expands, leading to a tightening of monetary conditions. Compared with this pattern, Korea's recent economic upswing has effectively been back-to-front. The recovery in demand has been led by very strong investment, which boosted import demand and brought about a deterioration (rather than an improvement) in the trade balance. Export growth, on the other hand, picked up less rapidly during 1993 than during the first year of previous upswings, and only reaccelerated dramatically towards the end of 1994 - almost two years into the recovery - and is still slower than import growth. We have argued before (see "Easy Money Fuels Speedy Recovery" in AMM, May-June 1994) that modest financial liberalisation and a partial and controlled opening of the capital account effectively amounted to a significant easing of monetary conditions, and that the external environment was conducive to an export boom. In this article we will argue that the export boom is likely to moderate during 1995, that the Chaebol (conglomerates) are (yet again) over-investing, and that the resulting excess demand will give way to a significant tightening of monetary conditions within the next 12 months.

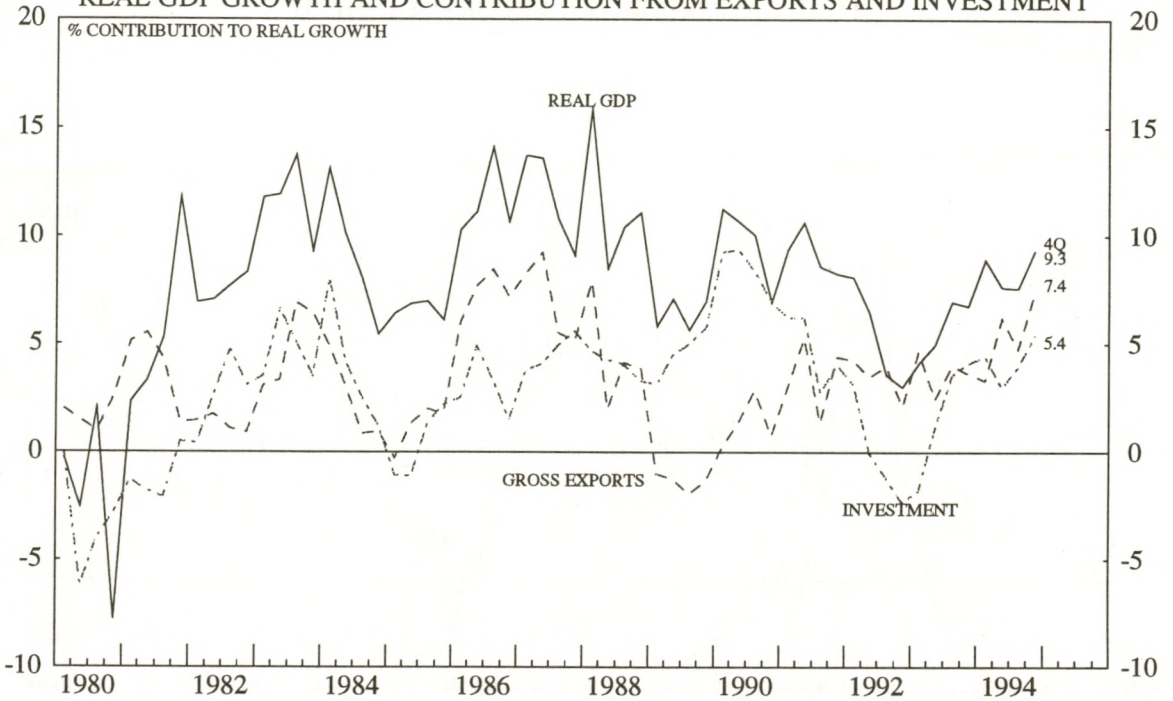
Balance of Payments

Although the trade and current account balances have been in deficit during the recent economic upswing, the overall balance of payments has been in surplus during the same period. This divergence is a result of various measures of financial liberalisation and limited opening of the previously tightly controlled capital account, e.g. opening of the stockmarket to foreign investors in January 1992, and gradual liberalisation of overseas borrowing by Korean companies. However, the capital account is still very tightly controlled; foreign investment in the stockmarket remains subject to constraining foreign share ownership limits (with resulting share-price premiums for foreign buyers) and foreign borrowing by domestic companies is still very limited. Plans to allow foreigners to buy domestic fixed-income securities look set to be drawn out and are unlikely to arbitrage away the large interest rate differential between local and international interest rates (7-8% for 3 year bonds), as the planned investment vehicles will be very limited in size (and possibly also in scope). There is still plenty of scope for capital account liberalisation, both on equity and debt flows, which (barring serious economic deterioration) would almost certainly attract further capital inflows. In other words, there is no question of the present current account deficit being unfundable, only of whether and by how much the policy makers are prepared to open further the sluice gates on the capital account, or whether they will try to reverse the trade and current account deficits by more traditional means such as moral suasion against imports and foreign travel.

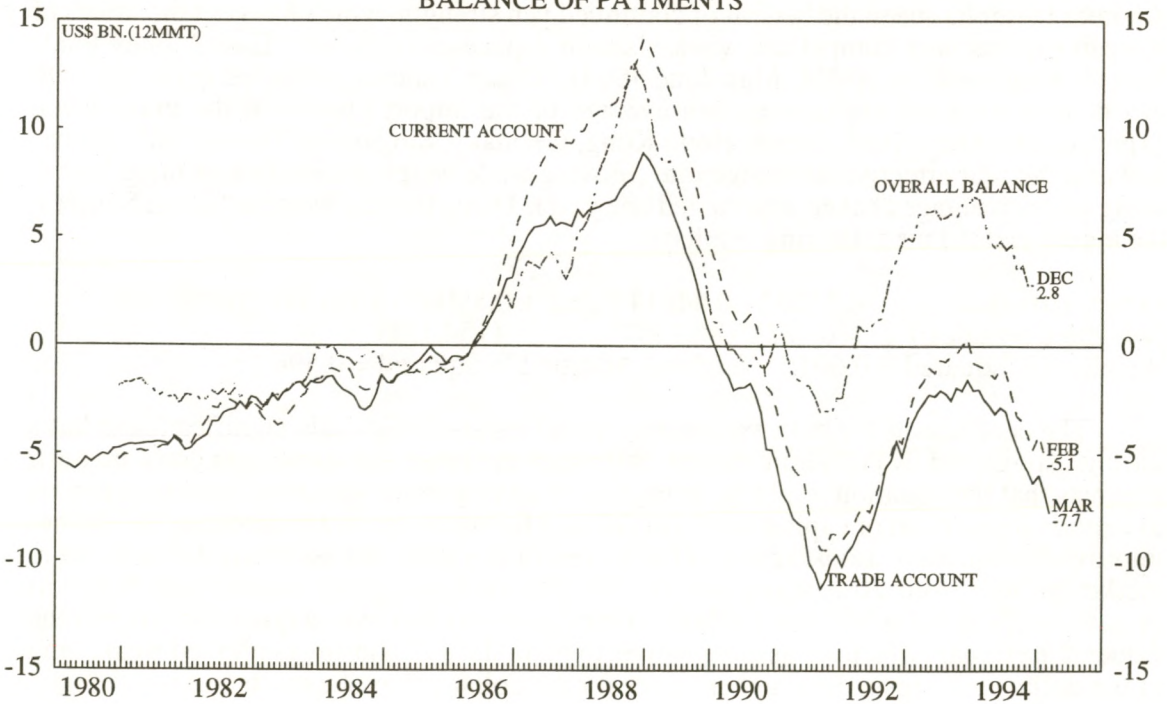
The recovery in Korea's export growth rate from negative in January 1993 to over 35% two years later has confounded most observers, many of whom had thought Korea's competitiveness had long since been eroded by wage inflation. The fluctuations in Korea's exports can be explained in large part by export market growth, although Korean exports have outperformed export market growth by 60%-80% most of the time, and the slowdown March-April 1995

S. KOREA: CHART 1

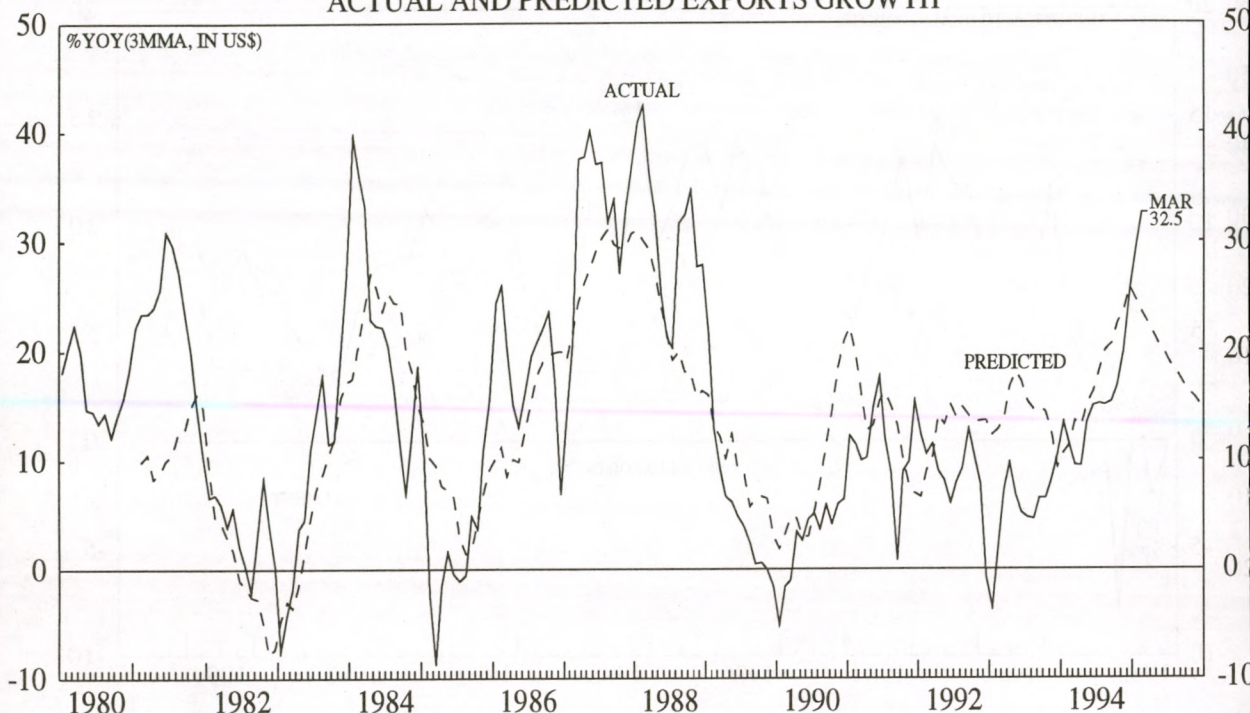
REAL GDP GROWTH AND CONTRIBUTION FROM EXPORTS AND INVESTMENT



S. KOREA: CHART 2
BALANCE OF PAYMENTS



S. KOREA: CHART 3
ACTUAL AND PREDICTED EXPORTS GROWTH

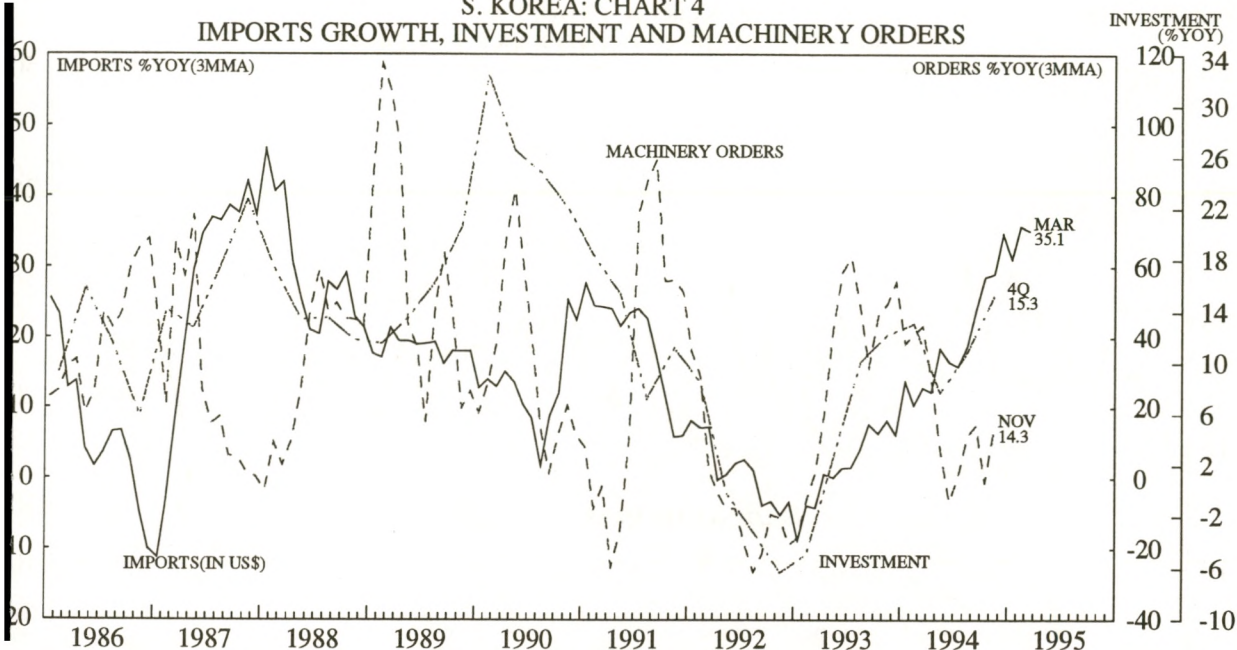


in Korean exports in 1989 was more far more severe than the slowdown in export markets. Another factor has been the benefit of continued yen strength, which has kept the prices of Korean exports very competitive vis-a-vis their Japanese rivals (see "Easy Money Fuels Speedy Recovery" in AMM, May-June 1994). Chart 3 shows predicted export growth based on market growth (a weighted average of the import growth of the main seven export destinations; USA, Japan, Hong Kong, Germany, Singapore, Taiwan and Indonesia) and the real effective exchange rate (moving trade weighted, wholesale price based, using yoy percentage change, and lagged one year). Using Robust Weighted Least Squares, the model yielded the following results:

$$\begin{aligned} \text{export growth} = & 4.11531 - 0.64814 \times \text{reer} + 0.890065 \times \text{market growth} \\ (\text{weighted t-values:}) & (60.485) (86.130) (154.131) \\ \text{Weighted R-squared} = & 0.601; \text{ Weighted Adjusted R-Squared} = 0.596 \end{aligned}$$

The coefficients for both explanatory variables are statistically significant and have the sign suggested by economic theory. Although the large and significant constant term suggests that the equation might be improved by adding more variables, various attempts to include investment or capital stock (to account for increases in export capacity) did not improve the equation. Looking ahead for the rest of this year, and assuming a slowdown in market growth from 20% at present to 12%, the model suggests moderation in export growth to 15-20% for 1995 as a whole. Of course, this forecast is quite sensitive to the value of the dollar (which we assume will recover modestly), and any continued weakening of the dollar could result in a higher figure for the dollar value of exports.

S. KOREA: CHART 4
IMPORTS GROWTH, INVESTMENT AND MACHINERY ORDERS

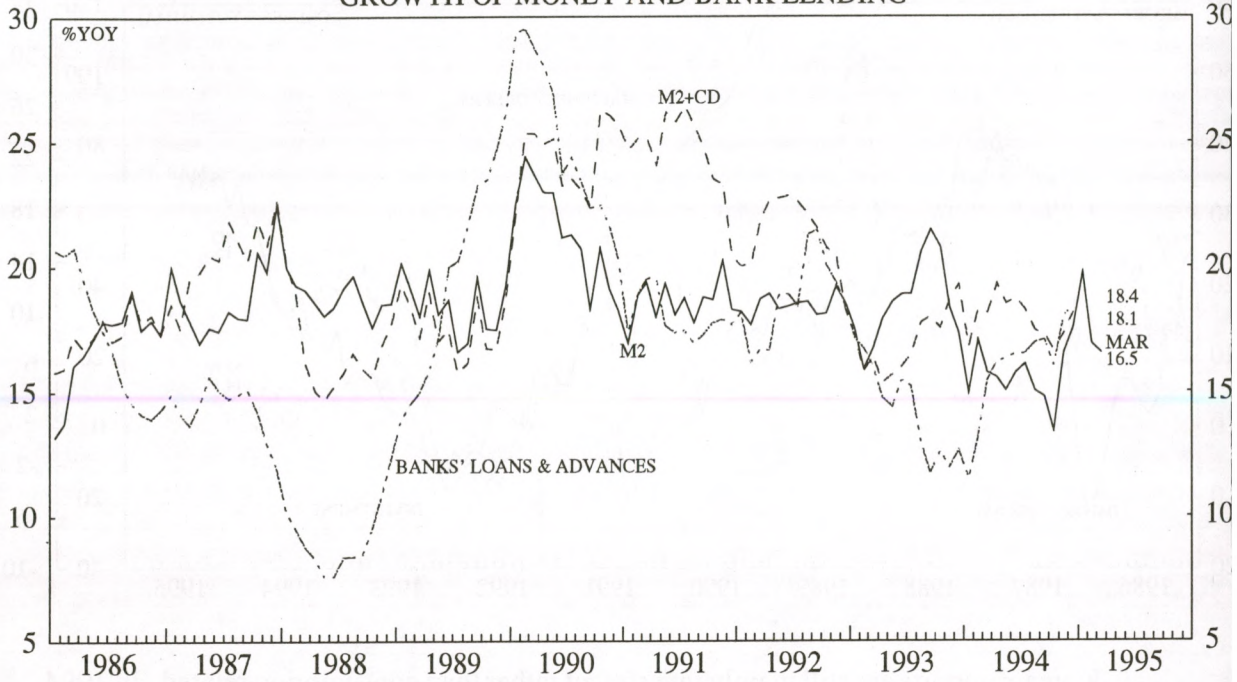


Korea's imports are still mainly investment rather than consumption related. In 1994, 37% of imports were machinery and transport equipment (and foreign cars are still relatively rare in Korea), 19% was materials and chemicals, 15% was fuels, only 5% was food and beverage, and a sizable proportion of the 24% of manufactured articles were intermediate goods rather than articles for final consumption. It is therefore not surprising that the recovery in investment and the attendant boom in machinery orders in 1993 and early 1994 goes some way towards explaining the surge in imports. Looking ahead, some observers suggest that the slowdown in machinery orders in late 1994 presages a slowdown in investment and imports. On the other hand, the various surveys of investment intentions of Korean companies all suggest continued strong investment activity over the next twelve months. Such bullish investment plans would appear to be based on expectations for exports even more bullish than our own projections, implicitly assuming that export markets will remain strong and that Korea will remain competitive due to continued yen-strength. In addition to private-sector investment, the government still has plenty of infrastructure investment plans (new airport, high-speed trains, replacement of old bridges, etc), although the construction component of these plans may well be less import-intensive than the renewal and expansion of the manufacturing sector's capital stock.

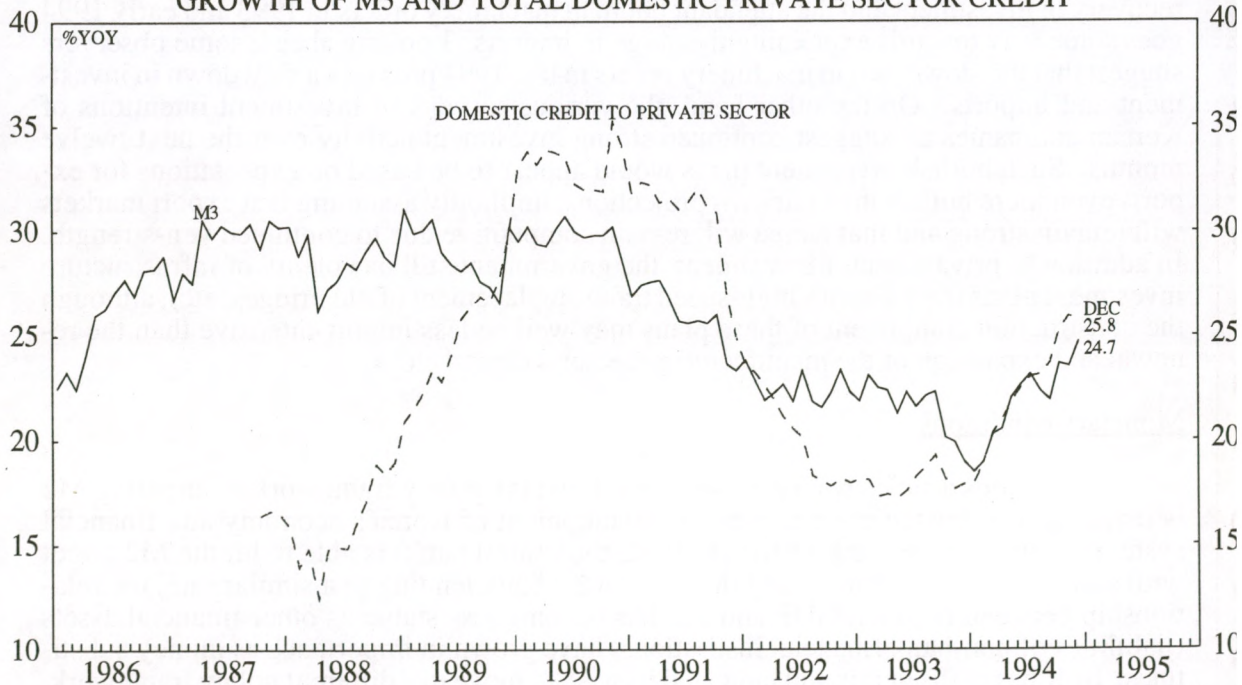
Monetary conditions

In previous articles we have long argued that the policy framework of targeting M2 is inappropriate for the current stage of development of Korea's economy and financial system. Although the Bank of Korea (BoK, the central bank) is able to hit the M2 target with a fair degree of accuracy and thereby curtail bank lending to a similar rate, the relationship between nominal GDP and M2 has become less stable as other financial assets (liabilities of non-bank financial institutions) have grown in importance as money substitutes. BoK has realised this and indicated its wish to move to a different policy framework. One possibility would be an eclectic monitoring of a range of monetary and other economic indicators with a view to targeting some definition of price stability - although such a vague Asian Monetary Monitor

S. KOREA: CHART 5
GROWTH OF MONEY AND BANK LENDING



S. KOREA: CHART 6
GROWTH OF M3 AND TOTAL DOMESTIC PRIVATE SECTOR CREDIT

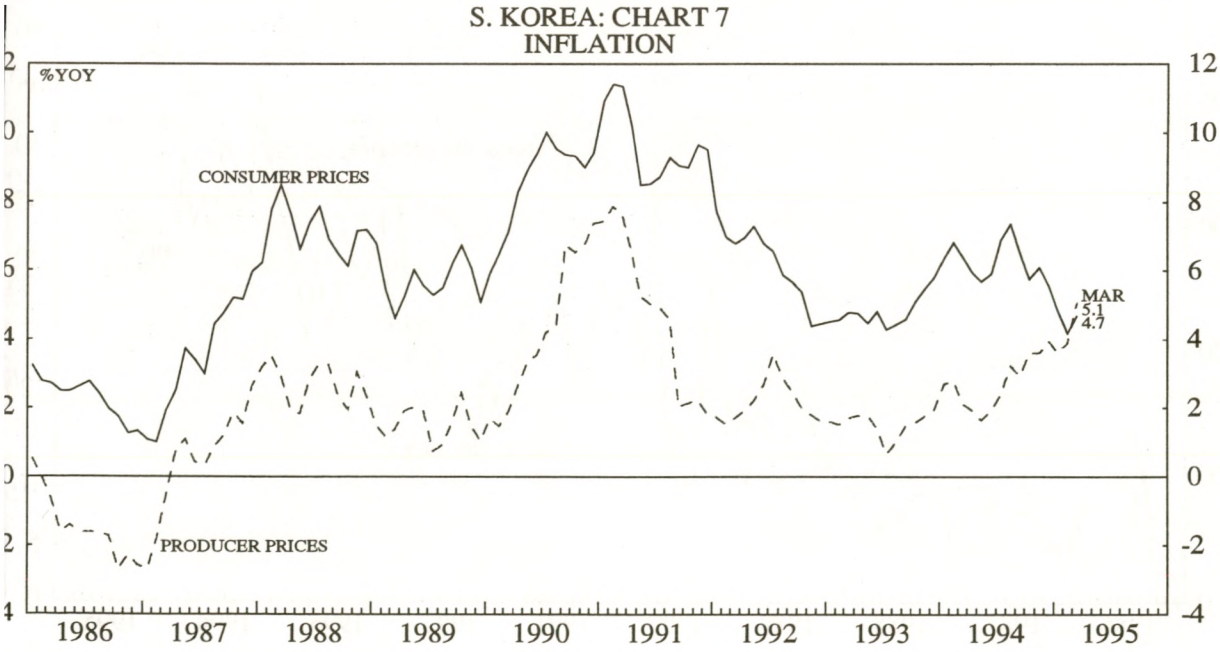


mandate could easily become subject to political manipulation. Another possibility would be to tinker with the system and widen the target to include CDs. However, our own calculations of M2+CDs suggests that the growth rate has only been materially different from M2 during periods of financial deregulation, and that therefore such a move might merely extend and prolong the adverse effects on the banking system of the current monetary policy framework.

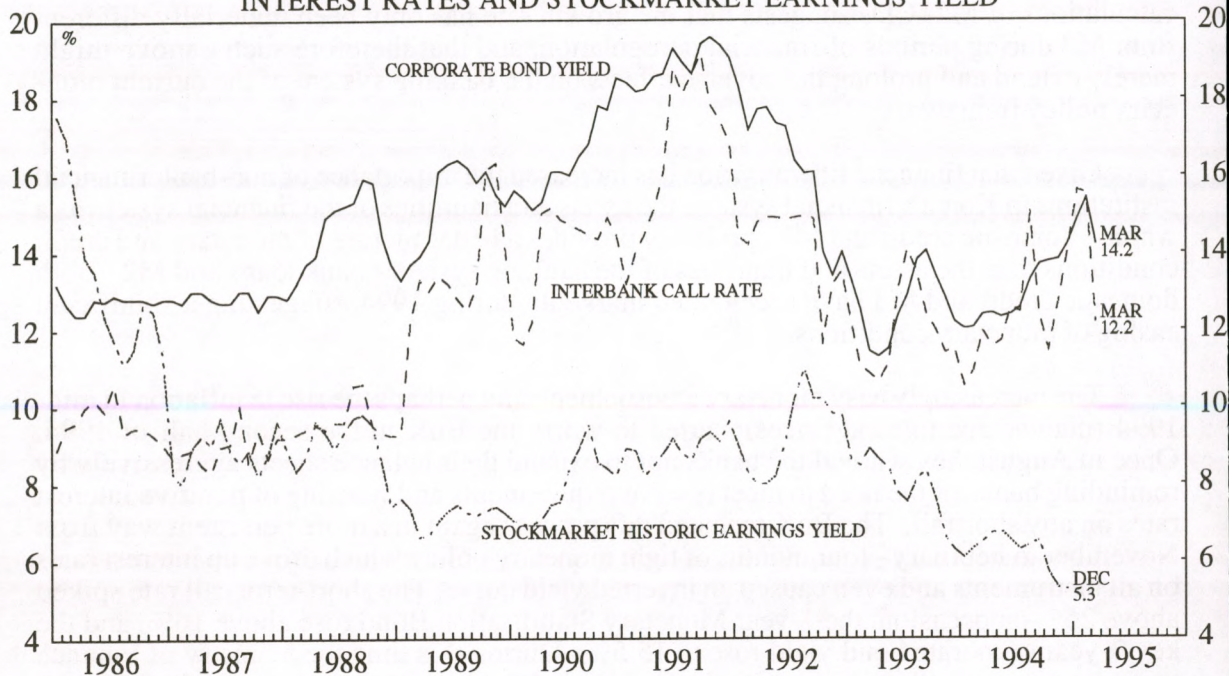
Given that financial liberalisation has increased the importance of non-bank financial institutions in Korea's financial system, the assets and liabilities of the financial system as a whole - domestic credit and M3 - probably provides a better picture of monetary and credit conditions than the assets and liabilities of the banking system - bank loans and M2. Both domestic credit and M3 have accelerated markedly during 1994, suggesting a significant easing of monetary conditions.

The increasingly easy monetary environment, and perhaps the rise in inflation in mid-1994 (mainly due to food-prices) started to worry the BoK in the second half of 1994. Once in August they warned the banks not to expand their balance sheets aggressively by reminding banks of the need to meet reserve requirements and warning of punitive interest rates on any shortfall. The BoK repeated this process again in a more persistent way from November to February - four months of tight monetary policy which drove up interest rates on all instruments and even caused an inverted yield curve: The short-term call rate spiked above 25% on occasion, the 1-year Monetary Stabilisation Bond rose above 16%, and the key 3-year corporate bond yield rose to 15.5%. During this time the Ministry of Finance was preoccupied with merging with the Economic Planning Board to become the Ministry of Finance and Economy (MFE), and the BoK therefore managed to implement a tighter monetary policy than one would normally expect Korea's traditionally growth-oriented government to tolerate. In February the MFE started to express a wish for lower interest rates and by early March the BoK started allowing interest rates to decline modestly.

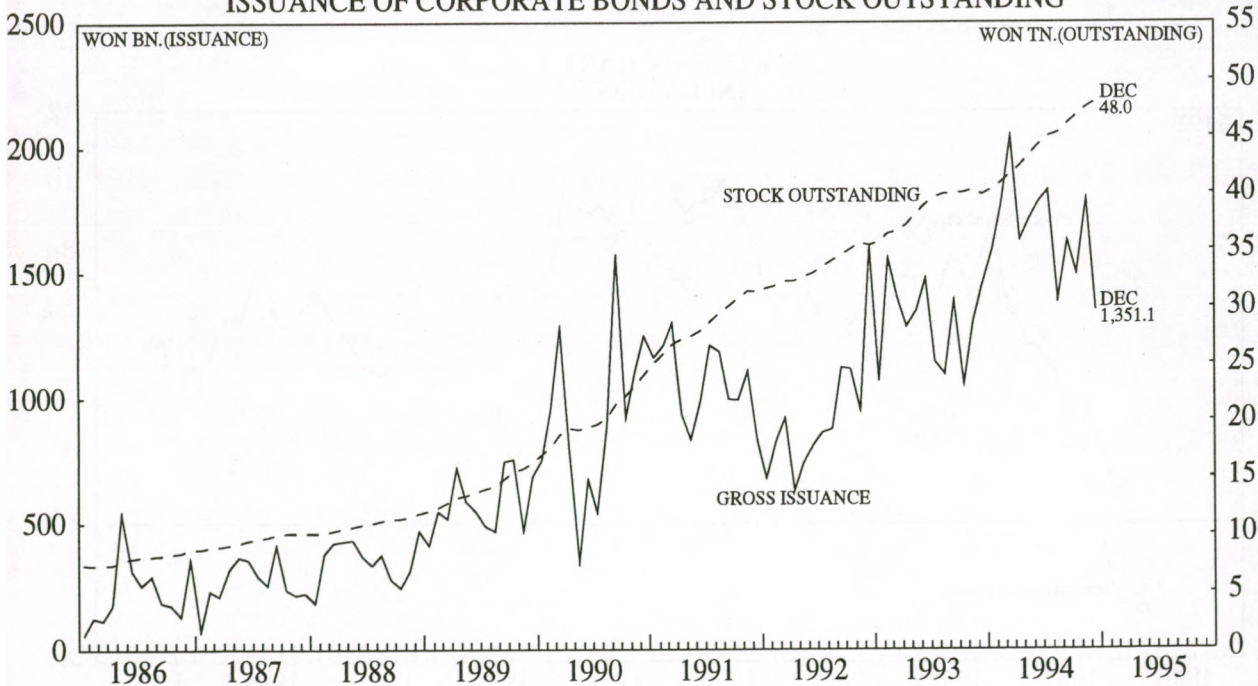
S. KOREA: CHART 7
INFLATION



S. KOREA: CHART 8
INTEREST RATES AND STOCKMARKET EARNINGS YIELD



S. KOREA: CHART 9
ISSUANCE OF CORPORATE BONDS AND STOCK OUTSTANDING



The fluctuations in the corporate bond yield have had serious implications for the stockmarket. For local investors, corporate bonds provide a low risk asset class with an attractive rate of return, compared with an equity market with a historic earnings yield of only 5%-6% and a dividend yield of just around 1%. Meanwhile, most companies still prefer not to dilute their ordinary share capital (still often controlled by founding families) with new equity issues, and therefore still have very high debt-equity ratios. However, Korean corporate treasurers are getting increasingly financially sophisticated and try to reduce the interest-rate cost of their borrowing by making full use of any opportunities for borrowing abroad, and by trying to time their domestic issuance of corporate bonds with lows in the bond yields (see Charts 8 and 9). The amount of corporate bonds in issue is now equivalent in size to a quarter of banks' lending to the private sector.

The current level of interest rates may well choke off activity by many small and medium-sized enterprises, but is unlikely to deter the big Chaebols from over-investing, as the Chaebols are not under effective shareholder pressure to maintain high rates of return on assets and are free to expand aggressively in their quest for market share. Given this strong investment-driven demand for credit, corporate bond yields are likely to rise to above 16% within the next 12 months, unless the government can curb investment activity by some other means - such as a combination of moral suasion and tighter administrative controls (e.g. on construction permits and on number of businesses a conglomerate can engage in).

SUMMARY AND CONCLUSIONS: Although M2 targets may well be met, monetary conditions (as measured by M3 or broad domestic credit) have eased significantly as a result of financial innovation and capital inflows, and have facilitated a too rapid recovery in demand, led by investment. The recovery in demand is rapidly narrowing the output gap, but has so far only had limited impact on the trade deficit and on inflation. A rise in inflation and/or a widening of the trade deficit to the point of prompting a tightening of economic policy is likely within the next 12 months. However, given the limited effectiveness of the interest rate transmission mechanism on the investment activity of the big Chaebols, the government may well have to resort to traditional administrative guidance and/or controls to curb the overheating. This, however, could well set back the process of financial liberalisation, which is needed precisely to improve the effectiveness of market-based economic policy tools.

PHILIPPINES HIGHER INTEREST RATES, LOWER PESO

From the viewpoint of monetary authorities in the Philippines, reverberations from the Mexican crisis are especially ill-timed. Buoyed by the relatively encouraging performance of the economy in 1994, policy makers looked determined to avail of ongoing political stability, and deliver more export-led growth in 1995, under continued watch of the IMF. The Mexican crisis however, and ensuing financial market scrutiny of the burgeoning Philippines trade deficit, injected unexpected volatility into the peso and threatened the possibility of unsustainably high interest rates in defense of the currency (note peak overnight interbank rates occasionally above 30% during March). While these higher interbank rates have been only partly transmitted to retail deposit rates and lending, arguably some monetary tightening is to be welcomed ahead of inflationary pressure and further deterioration of the trade deficit. The following article discusses both these related themes: the prospects for inflation, and also the wider issue of trade deficit sustainability. It suggests that even in the absence of supply-side shocks, the inflation threat from a growing monetary overhang is likely to be significant in the medium-term. In any case, immediate monetary tightening will need to be sustained if vital foreign currency inflows are to be defended in the face of a widening trade deficit.

Recovery in 1994

After years of economic malaise and underperformance, economic indicators in 1994 showed encouraging signs of a recovery driven by growing foreign investment. Chart 1 shows that real GDP growth of 3.9% in 1994 was buoyant when compared with the previous year's growth of 2.1%; while real GNP growth in 1994 significantly exceeded government expectations (table 1). Consumer price inflation (Chart 2) fell from above 10% early in the year to 7.1% by December. Foreign investments are estimated to have risen by \$1.2 billion (net), placing strong upward pressure on the peso, which in turn dampened export growth. Import growth however remained robust, widening the trade deficit (Chart 3) to around 5.0% of GDP. As shown in Chart 4, base money growth resulting from foreign exchange inflows was mostly sterilised by the issue of short-term government paper although ongoing relaxation of bank reserve requirements supplied a steady boost to the monetary base throughout 1994. The fiscal side was contractionary; a consolidated fiscal deficit of around 2.3% of GNP in 1993, moved to a surplus by November 1994 (Chart 5), helped by a positive fiscal balance of P25bn recorded so far on the national government account.

TABLE 1
PHILIPPINES: MACROECONOMIC INDICATORS

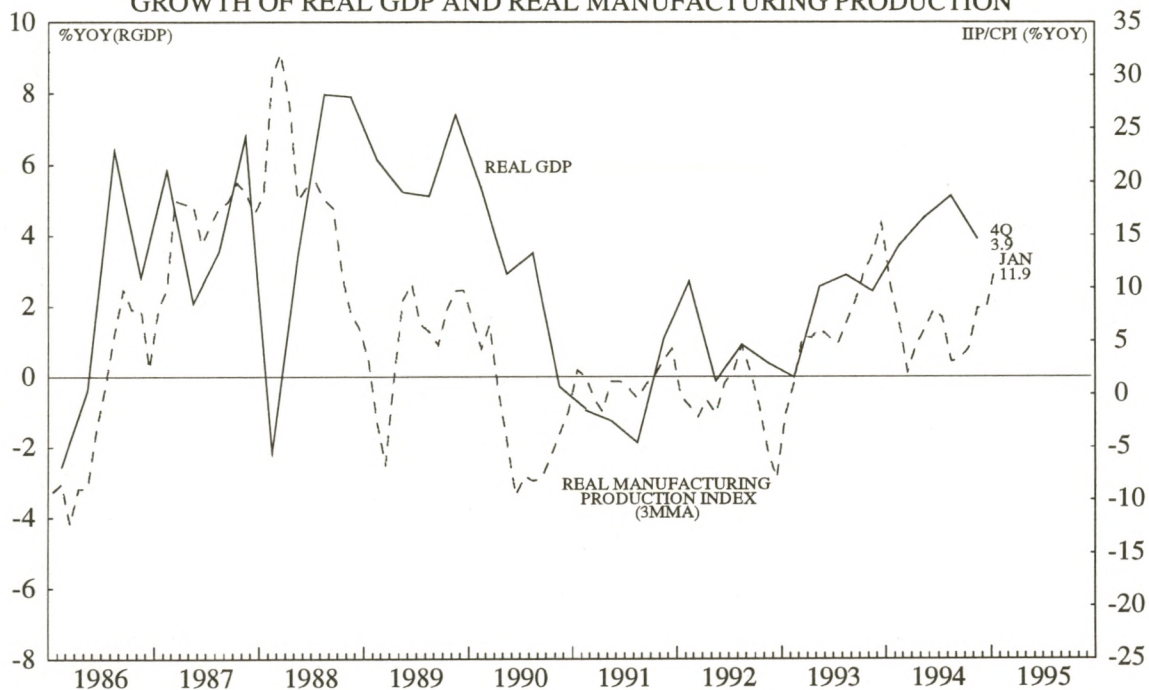
	<u>1994</u>		<u>1995</u>
	Actual	Target*	Target*
(1) Real GNP Growth	5.1%	3.5-4.5%	6.0-6.5%
(2) Inflation (year average)	9.1%	9.5%	6.5% (Dec)
(3) Reserve money growth (year average)	6.1%	-	-
Current account deficit (as % of GDP)	5.0% ^(e)	-	-
Consolidated Public Sector balance (Peso bn)	+13.8 ⁽¹⁾	-21.2 ⁽¹⁾	-
National Government balance (Peso bn)	+25.0 ⁽¹⁾	-6.8 ⁽¹⁾	-

* The above represent published national government targets.

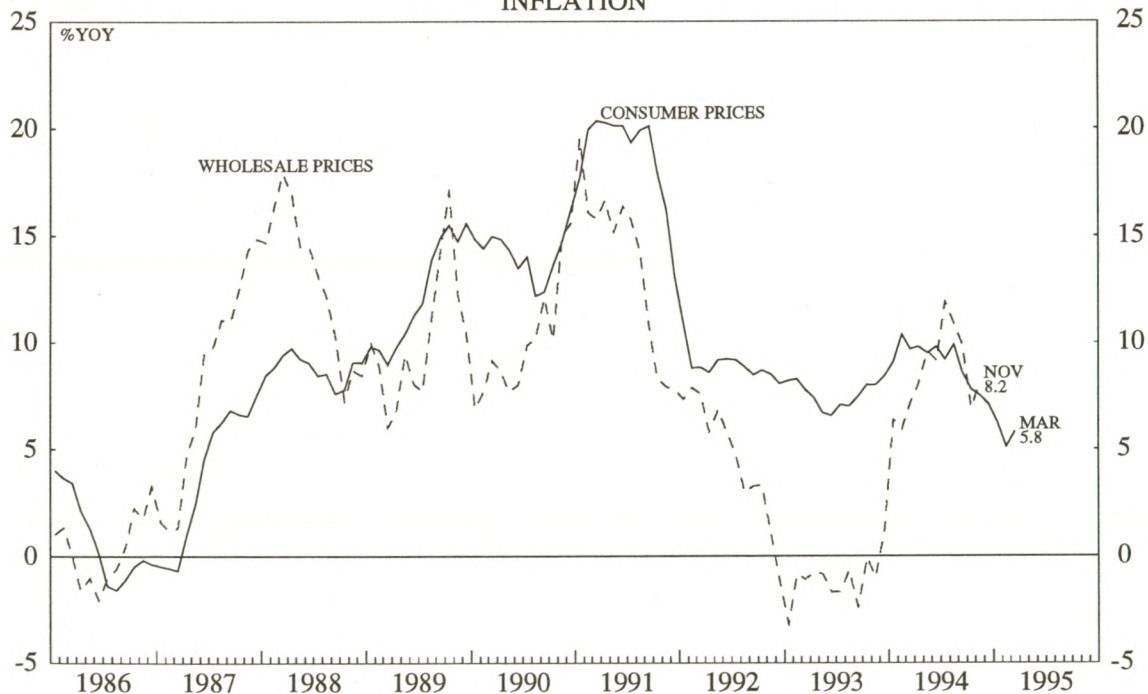
⁽¹⁾ January-November; Dept. of Finance preliminary figures

^(e) estimated

THE PHILIPPINES: CHART 1
GROWTH OF REAL GDP AND REAL MANUFACTURING PRODUCTION

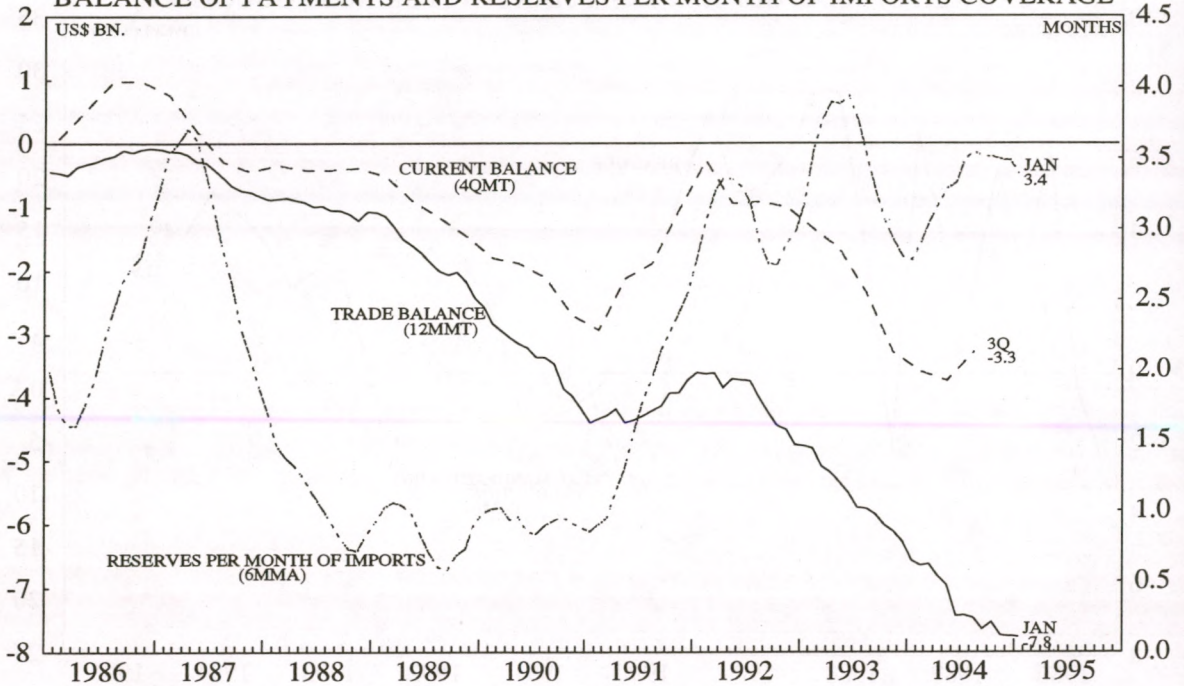


THE PHILIPPINES: CHART 2
INFLATION

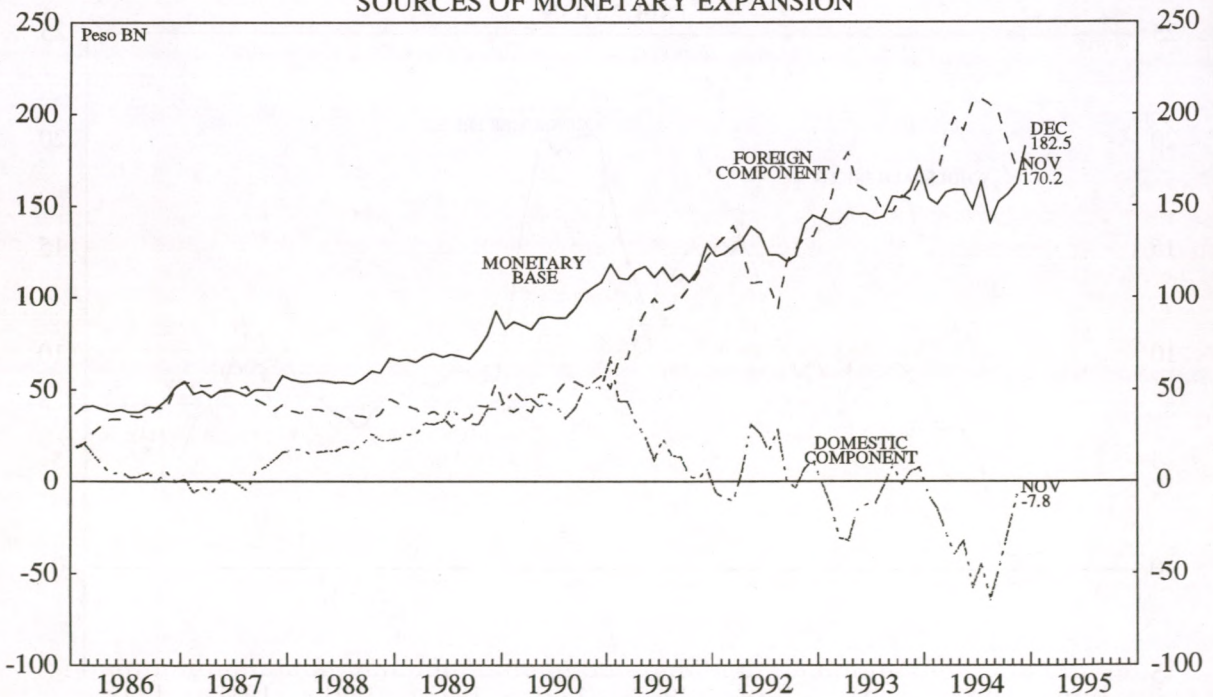


THE PHILIPPINES: CHART 3

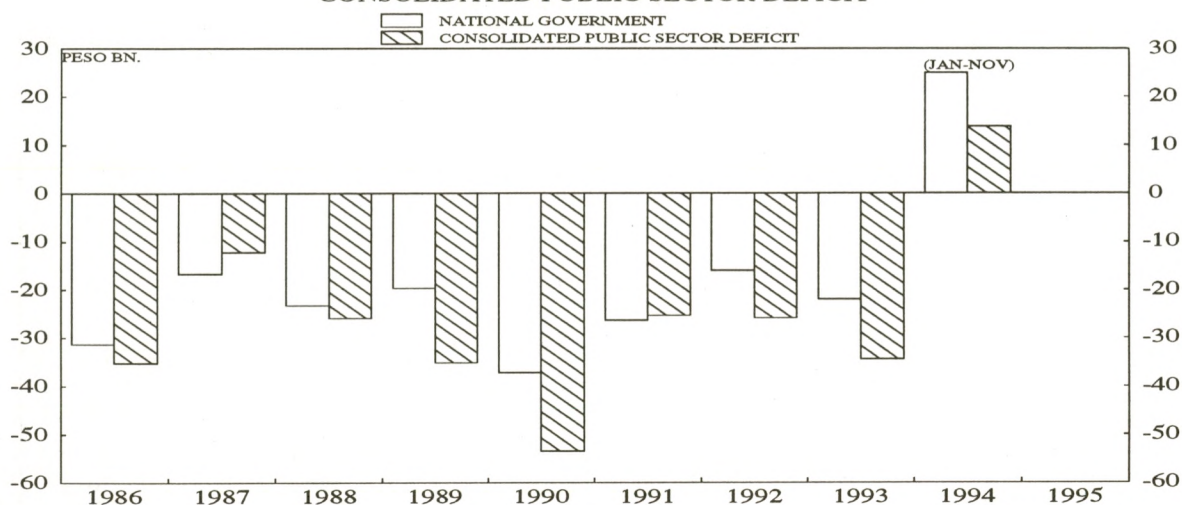
BALANCE OF PAYMENTS AND RESERVES PER MONTH OF IMPORTS COVERAGE



THE PHILIPPINES: CHART 4
SOURCES OF MONETARY EXPANSION



THE PHILIPPINES: CHART 5
CONSOLIDATED PUBLIC SECTOR DEFICIT



Inflation and money growth

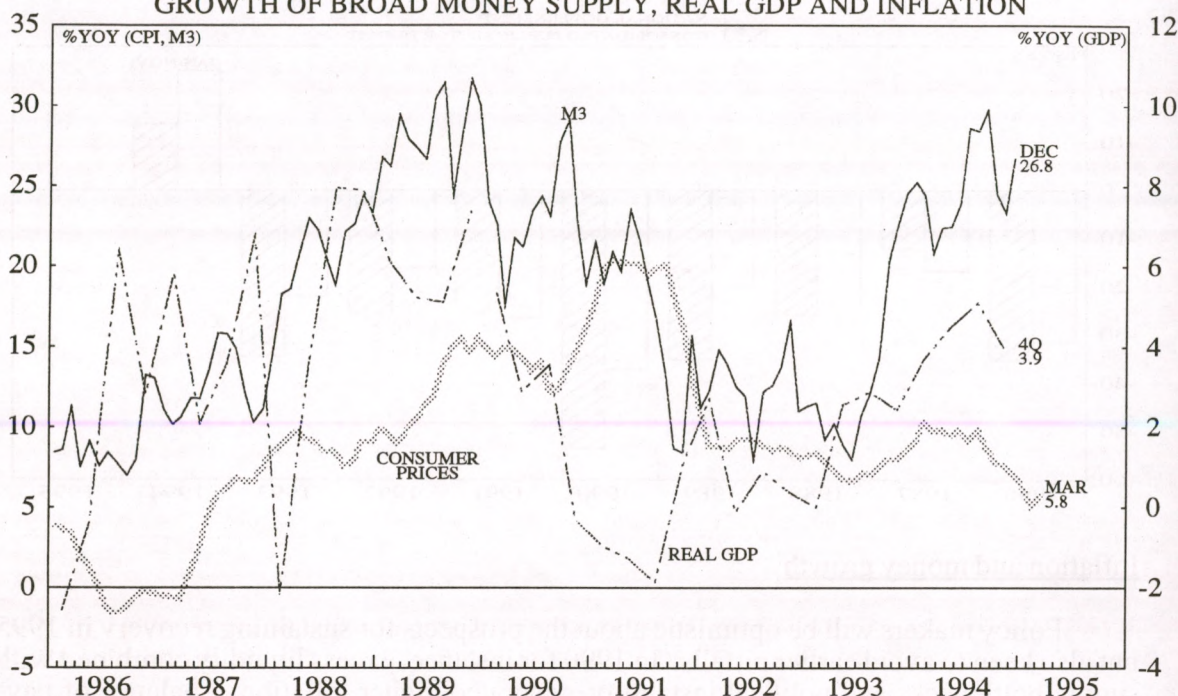
Policy makers will be optimistic about the prospects for sustaining recovery in 1995 but also keen to avoid earlier pitfalls. In 1990 for instance, excess liquidity combined with supply bottlenecks and political instability, generated higher inflation, a balance of payments deterioration, and eventually devaluation of the peso. Although in the present cycle the central bank (Banco Sentral ng Pillipinas - BSP) can take heart from its broad adherence to IMF base money targets and relatively subdued inflation, it will be acutely aware of the negative consequences of M3 liquidity acceleration to over 26% (yoy) over the past year, driven by strong loan demand growth, mainly for consumer credit and housing finance.

Chart 6 shows the relationship between nominal money growth and the components of nominal GDP. Even within the narrow time-frame depicted by the chart, relative movements of money, inflation, and real GDP fit neatly into the established pattern of standard monetary cycles -- with a two-year lag, approximately, between money growth and inflation. For instance, the mid-1989 peak in nominal money growth coincided, as expected, with a peak in real GDP although inflation continued to rise in a predictable way for two years until mid-1991. Meanwhile, the collapse in real GDP to its ebb in 1991, driven by a rapid deterioration of the trade deficit, is also a well established and late feature of the monetary cycle. In the present recovery phase, therefore, it is not surprising to see inflation somewhat subdued by the sharp slowdown in monetary growth during 1992 and 1993. Moreover, given the acceleration in M3 since mid-1993, it is plausible to project the re-ignition of inflation in late 1995 and into 1996, repeating the pattern seen during the 1987-1991 inflationary period.

Monetary overhang

Monetary theory suggests that, given a stable money demand function, inflation will result from "excess" nominal money growth, over and above that needed to finance growth in nominal GDP. This will be especially true if the economy is operating at or near productive potential. One method of investigating for the possibility of excess monetary growth is by looking at Marshallian k (Chart 7); the ratio of money stock to nominal GDP, and

THE PHILIPPINES: CHART 6
GROWTH OF BROAD MONEY SUPPLY, REAL GDP AND INFLATION

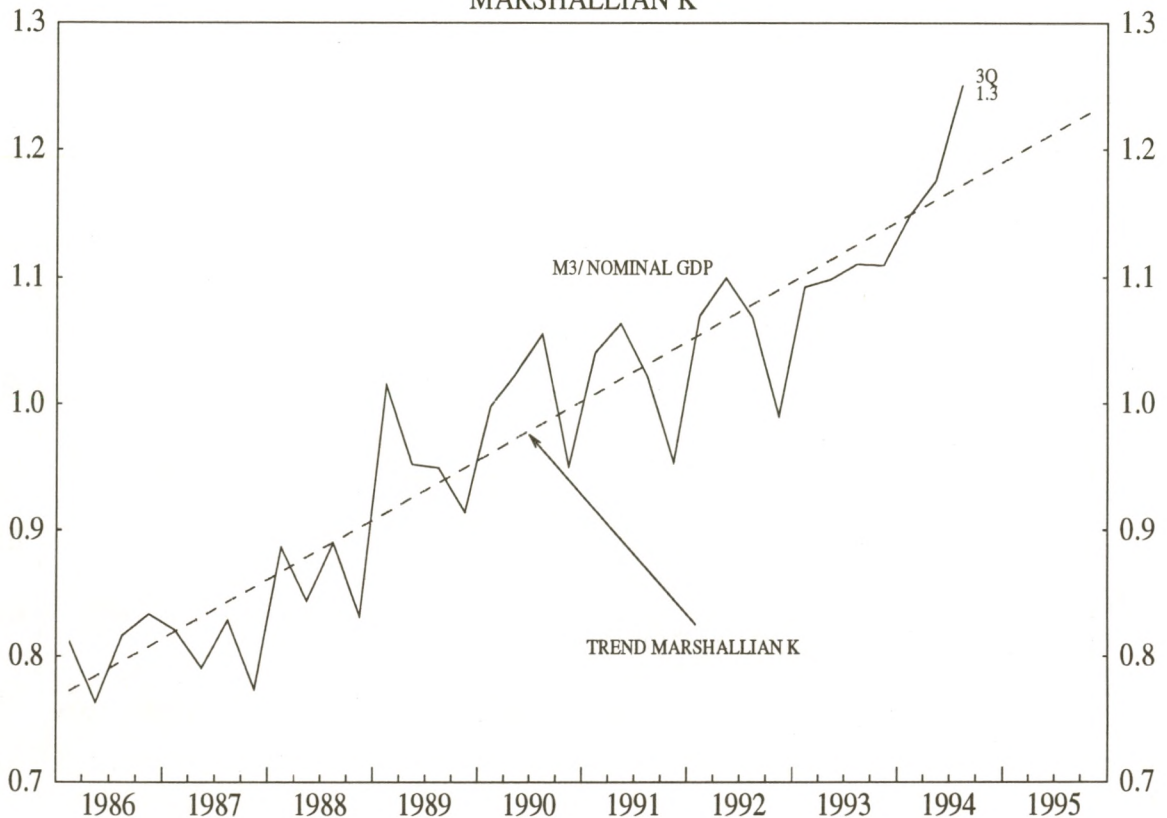


particularly the deviation of Marshallian k from its trend growth. In this framework, the persistence of an above trend ratio of money balances to GNP, since 1994 Q1 for example, represents a monetary overhang. With real GDP already at its thirty year trend rate (around 4%) and signs of slowing within the manufacturing sector (Chart 1), the unwinding of such a monetary overhang will supply a sharp medium-term boost to the rate of price inflation. Assuming only slight increases in productive potential in the next twelve months, it is likely that excess nominal aggregate demand, implied by above trend growth in Marshallian k , will push inflation upwards towards 10% by end-1995, and possibly beyond by 1996 Q1, mirroring the pattern of excess monetary growth and inflation seen in 1989 and 1990. Demand pull factors in the present cycle will be assisted on the cost-push side by robust wholesale prices (Chart 2) and secondary effects arising from our expectation of a peso depreciation in 1995.

Erosion of the fiscal surplus

The forecast for a sharp monetary boost to inflation rests on the realistic assumption that any fiscal deficits arising in 1995 are not funded by the central bank. Despite strong efforts by government to rein back public expenditure, the impressive national government surplus recorded in 1994 (chart 5) is likely to be reduced significantly in the coming year, owing to increased public spending ahead of May 8 senatorial elections, and a reduction in privatisation proceeds (these contributed around P 4bn to the estimated national government surplus in 1994). From a monetarist perspective, the absolute level of a deficit is less important than the source of its finance. It is expected after the elections in May, funding through banks will resume - redistributing funds across sectors - with little negative implication for the money supply. In the present recovery phase, however, as banks find more lucrative lending opportunities in the private sector, public sector funding from banks will

THE PHILIPPINES: CHART 7
MARSHALLIAN K

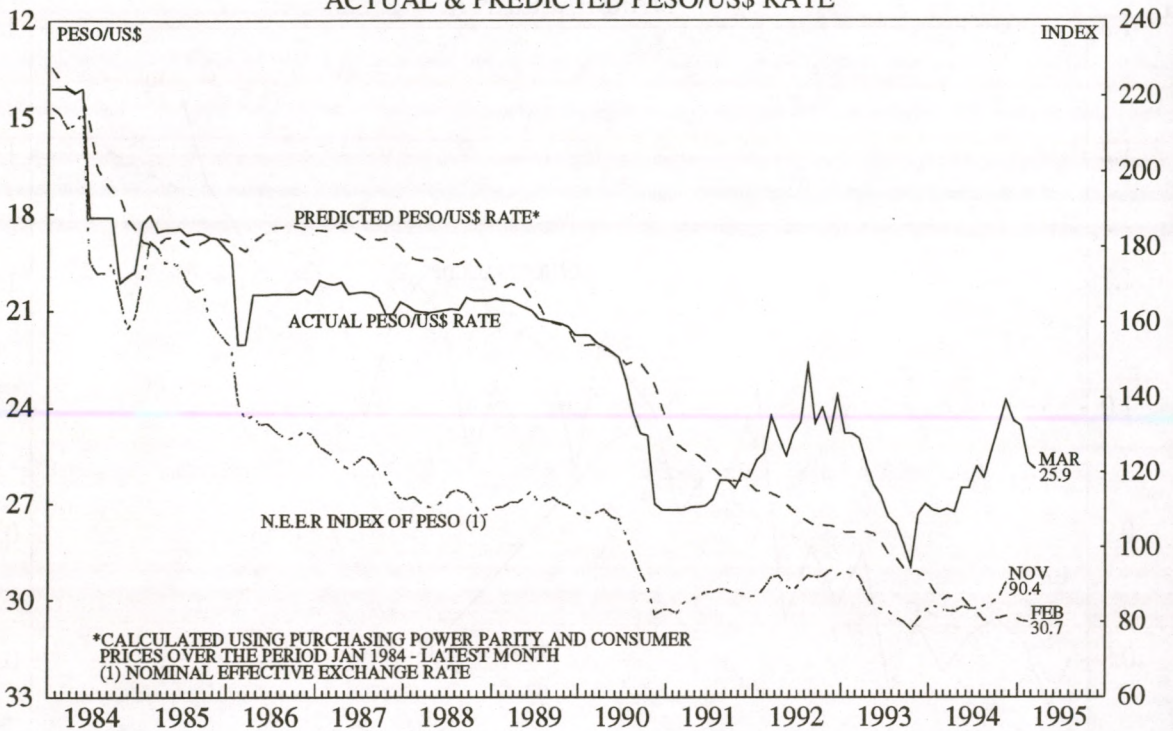


be forthcoming only at much higher cost. Indeed, the bellwether 91-day Treasury Bill rate (T-Bill) has risen by over 450 basis points in the past six months alongside rapid growth in private sector credit.

Financing the trade deficit

Expected inflation in 1995 will erode an element of export competitiveness but around 20% (yoy) average growth in exports, comparable to last year, should be encouraged by our expectations of peso depreciation this year. The trade deficit will widen nevertheless, particularly as debt-driven consumption and capital imports gather pace. Indicators already show consumer imports growing at 34% (yoy) to September 1994, albeit from low levels. While orderly depreciation of the peso in 1995, in response to these developments, would not have been resisted by policy makers, arguably ripples from the Mexican crisis have accelerated this process and, in doing so, reduced the flexibility of monetary policy operations. More worryingly, the sudden outflow of foreign currency has exposed a short-term financing gap that can only be reasonably filled through reserves decumulation. Foreign currency reserves have stabilised at just over three months import cover (Chart 3) although authorities will continue to battle for stability of the peso. Continued IMF financial assistance will provide an element of balance of payments support as will the modest increases in other external borrowings recorded during 1995 Q1.

THE PHILIPPINES: CHART 8
ACTUAL & PREDICTED PESO/US\$ RATE



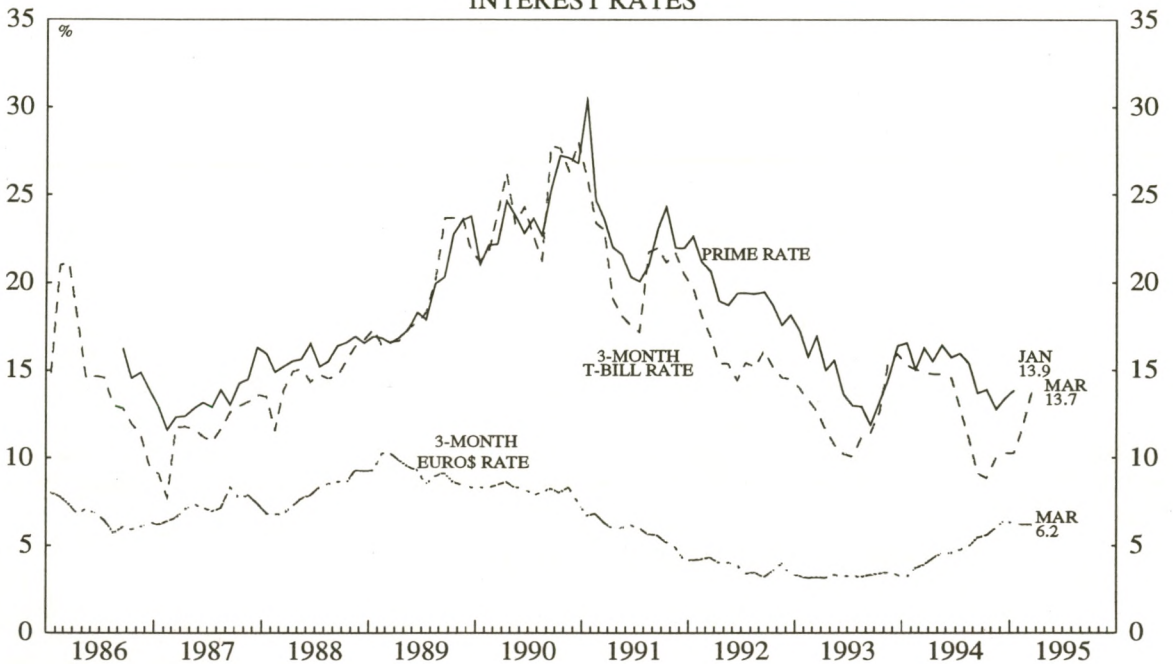
Defending the peso

Alongside tight inflation discipline, confidence in the peso will be a key element of monetary policies presently aimed at attracting and retaining vital private capital inflows. Even at current nominal exchange rates against the US dollar, the peso remains overvalued on a purchasing power parity basis (Chart 8) and more downward pressure is to be expected in the short-term. So far, sharp peso depreciation has been resisted through a number of measures including: vigorous central bank intervention in the foreign exchange markets; penal interbank interest rates; the suspension of computerised peso trading on breach of the 1.5% fluctuation limit against the US\$; and changes to banking supervision arrangements. These actions have stabilised the peso at slightly lower levels around P26 per US dollar representing a 6% depreciation since January. Indeed, given the market rigidities in foreign exchange trading of the peso described above, it is unlikely that the currency will be subject to immediate devaluation pressure as a result of speculative sales. Nevertheless, a managed drift downward towards P29 per US dollar over twelve months is unlikely to be resisted.

Higher interest rates

In the short-term pressure on the peso will continue, and it is likely that interest rates will have to rise across the yield curve if defense of the peso is to be successful in retaining much needed short-term foreign capital. During late February, the BSP resisted the transmission of high overnight interest rates to longer term rates by the rejection of tenders at its

THE PHILIPPINES: CHART 9
INTEREST RATES

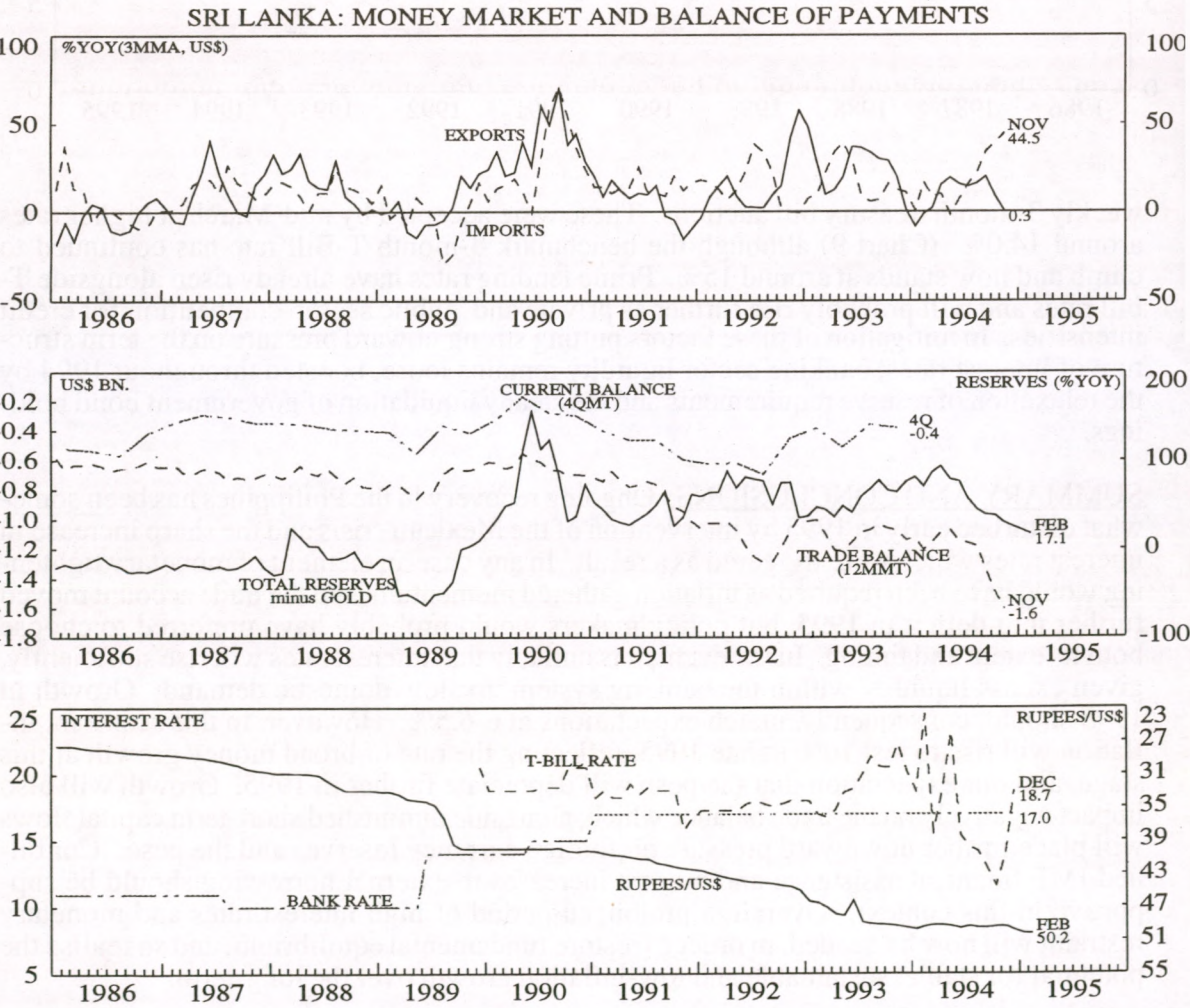


weekly 3-month treasury bill auctions. These were accepted by mid-March at higher rates around 14.0% (Chart 9) although the benchmark 3-month T-Bill rate has continued to climb and now stands at around 15%. Prime lending rates have already risen alongside T-bill rates and will probably rise further as private and public sector competition for credit intensifies. In mitigation of these factors putting strong upward pressure on the term structure of interest rates, banking sector liquidity remains loose, boosted throughout 1994 by the relaxation of reserve requirements and the steady liquidation of government bond holdings.

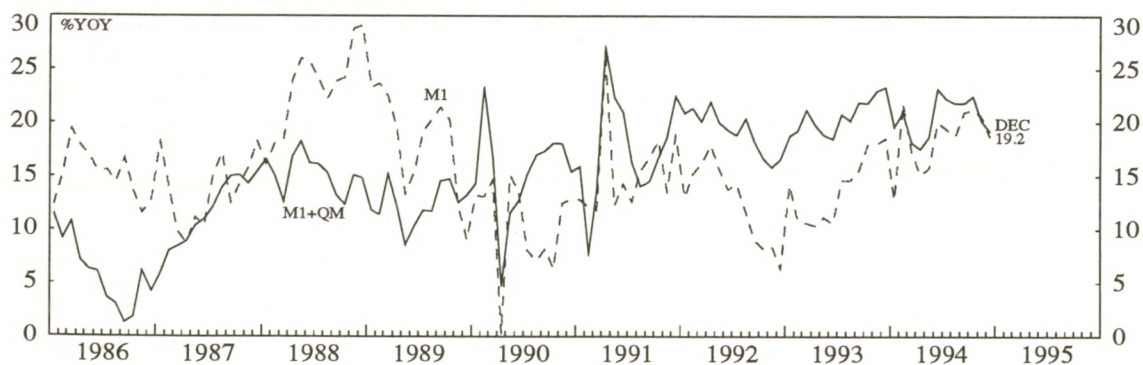
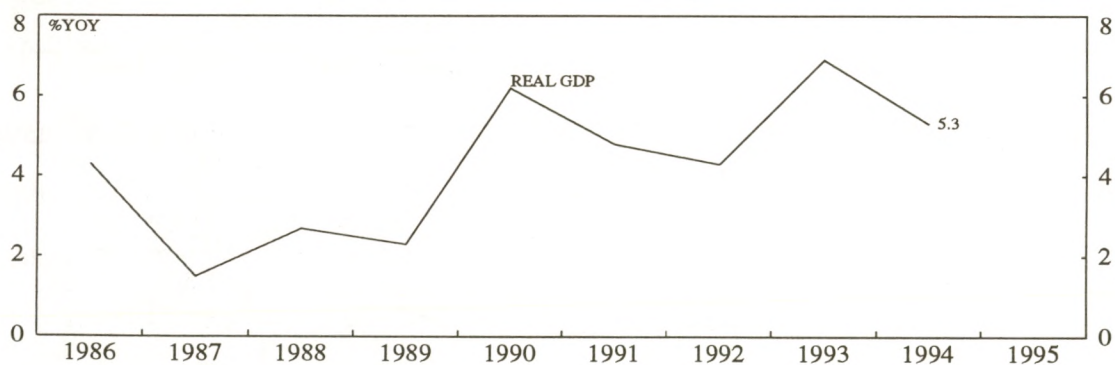
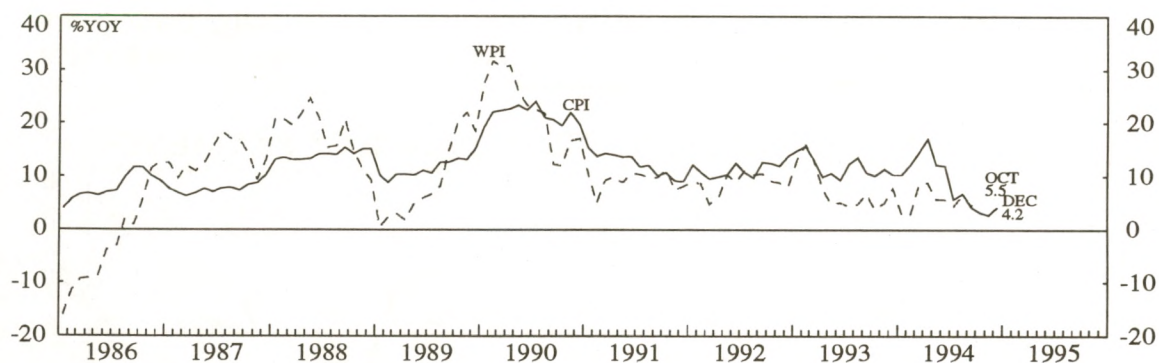
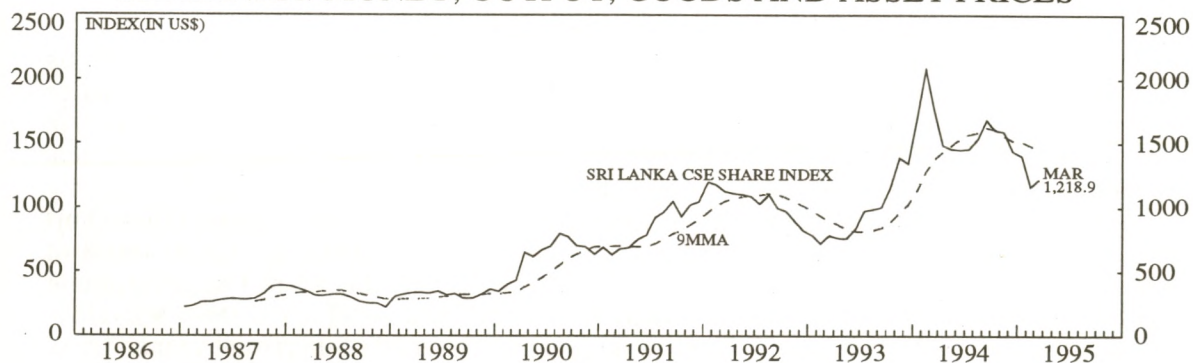
SUMMARY AND CONCLUSIONS: Ongoing recovery in the Philippines has been somewhat disturbed early in 1995 by intervention of the Mexican crisis and the sharp increase in interest rates which were triggered as a result. In any case an element of monetary tightening would have been required as inflation gathered momentum, and the trade account moved further into deficit in 1995, but policy makers would probably have preferred to choose both its extent and timing. In the event, it is unlikely that interest rates will rise sufficiently, given excess liquidity within the banking system, to slow domestic demand. Growth in 1995 should, consequently, match expectations at 6-6.5%. However, in this scenario, inflation will rise to test 10% in late 1995, reflecting the rate of broad money growth at this stage, and our expectation that the peso will depreciate further in 1995. Growth will also impact negatively on the trade balance which, alongside diminished short-term capital flows will place further downward pressure on foreign currency reserves and the peso. Continued IMF financial assistance and modest increases in external borrowing should be supportive in this context. Overall, a prolonged period of high interest rates and monetary restraint will now be needed, in order to restore fundamental equilibrium, and so realise the potential for stable, sustainable and low-inflation growth over the long-term.

SRI LANKA: GROWTH SHIFTS INTO LOWER GEAR

The government of Sri Lanka views the CSE Share Index as a barometer of market confidence in its economic policies and ongoing reform programme. In that sense, the steady fall in the index throughout 1994 may be interpreted in terms of lower economic growth expectations for 1995, and residual uncertainty on the political front. Indeed, a worsening trade balance and infrastructure problems will continue to impact negatively on growth. More-over political difficulties in implementing labour reforms, within the government's privatisation programme will also hamper production. Monetary conditions have tightened considerably since 1994 Q4, as short-term capital inflows, which supported the liquidity boost in 1994, slowed to a trickle. Furthermore, an overhang of government debt on bank's balance sheets and a growing fiscal deficit is placing strong upward pressure on T-Bill rates. Therefore, with little market appetite for government debt at present, the fiscal deficit is being partly financed by the central bank in order to check the rise in interest rates. Inflation has been subdued by price controls and subsidies which are placing additional pressure on the budget deficit. On the external side, given protracted deterioration in trade accounts, the Rupee is likely to fall further against the US\$ to enhance export competitiveness.



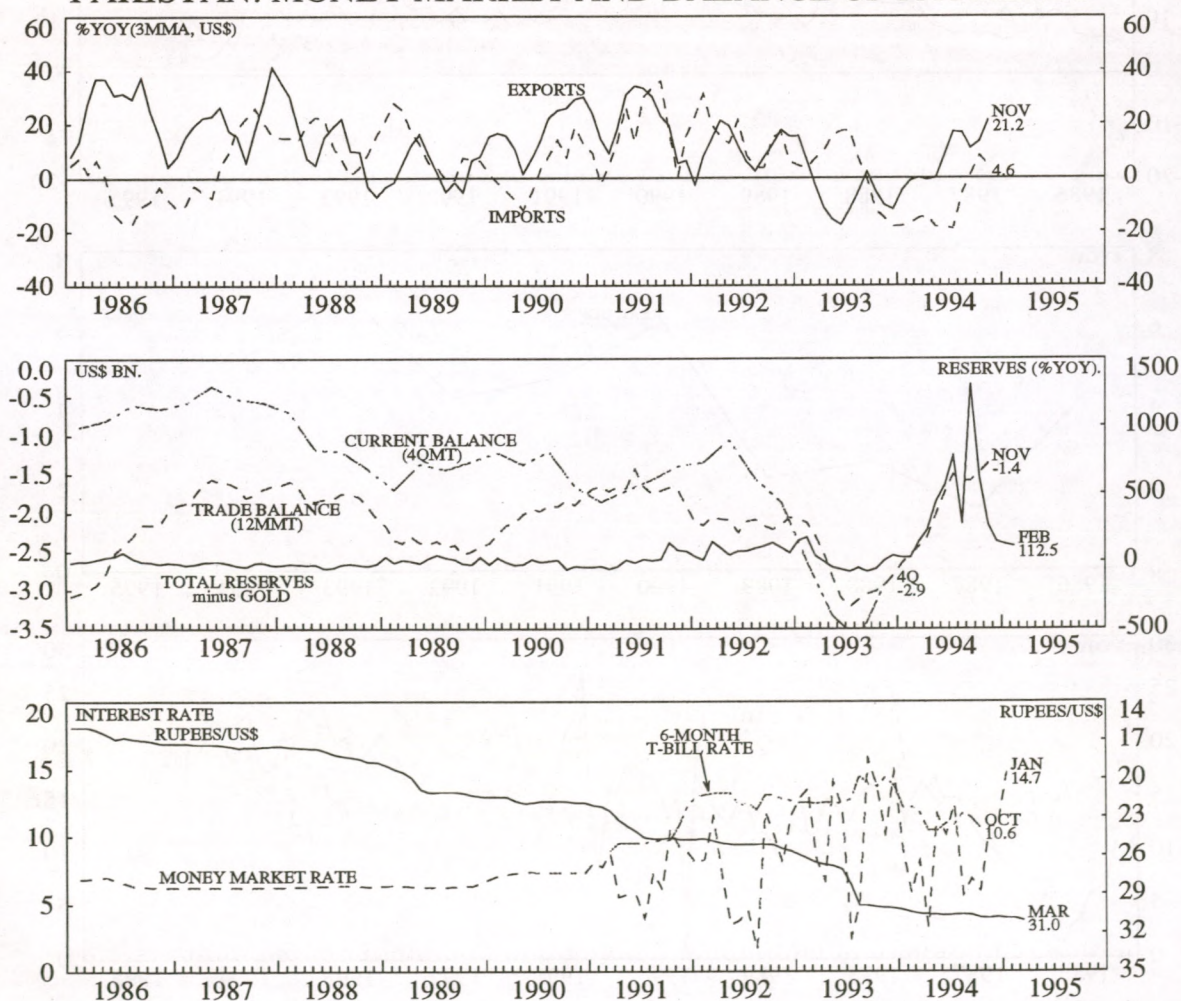
SRI LANKA: MONEY, OUTPUT, GOODS AND ASSET PRICES



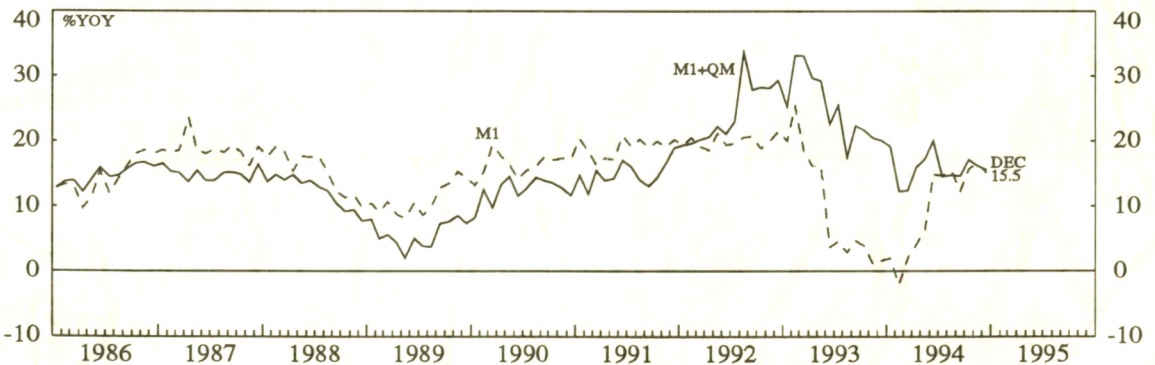
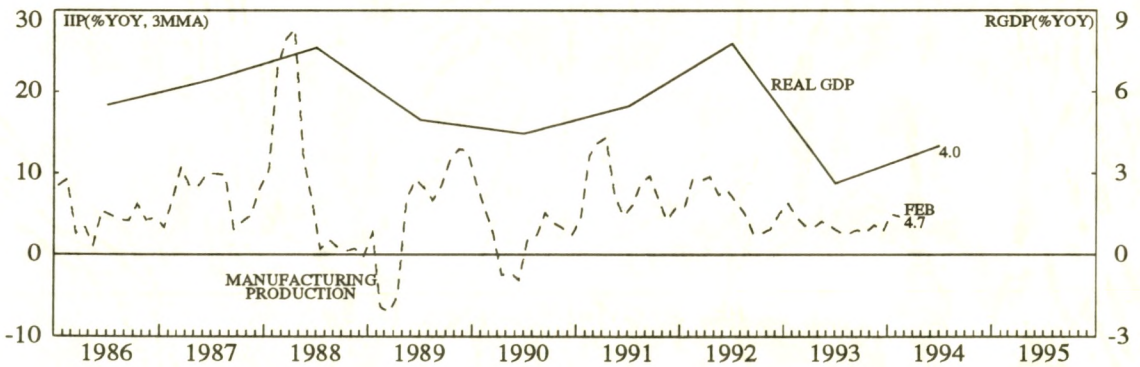
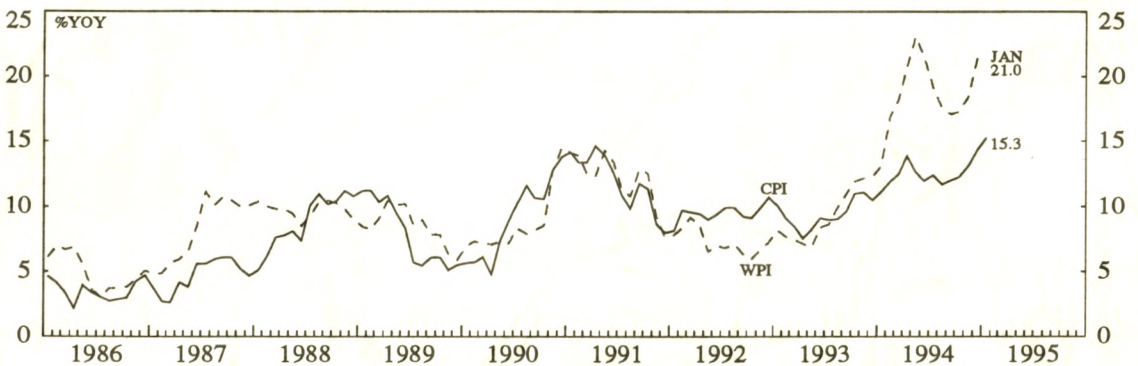
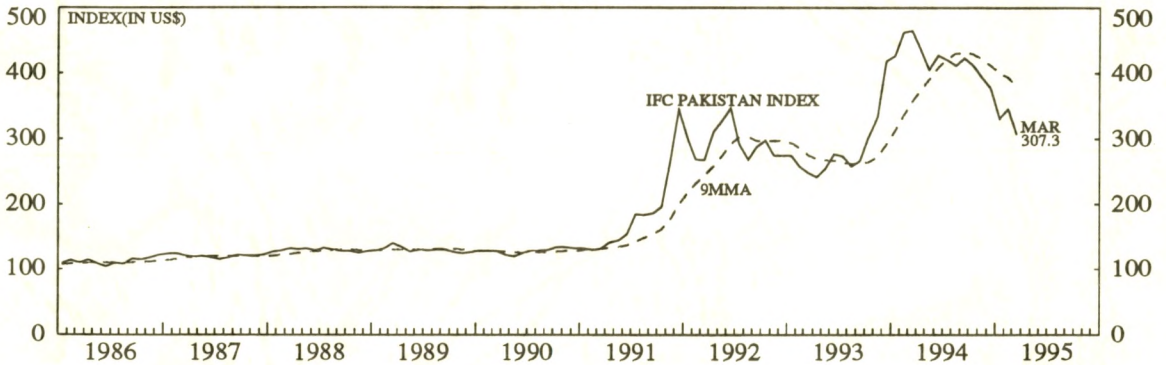
PAKISTAN: A POOR COTTON HARVEST AND GREATER INVESTMENT UNCERTAINTY

During 1994 Pakistan saw a turnaround in its balance of payments position. The strong influx of capital from the end of 1993 to the end of 1994 boosted official foreign exchange reserves and supported the equity market until the US financial asset markets and those in Asia corrected. At present the monetary conditions appear fairly benign although real economic growth has not fully recovered from the downturn in 1992-93 because the economy has suffered from a string of poor cotton crops (the most recent harvest having fallen short of government expectations). Consequently industrial production and exports (60% of which are cotton or cotton based) are unlikely to grow strongly this year. The government has recently revised its growth target downwards from 7% to 4% for FY 1994-95. Government revenue collection was 37% below target in the first half of this fiscal year so fiscal overspending will likely mean that the 4% of GDP target for the consolidated fiscal deficit is breached. Infrastructure projects and other investments involving foreign participation may continue to be frustrated by the escalating violence and political upheaval in Karachi. This has adversely impacted stockmarket sentiment.

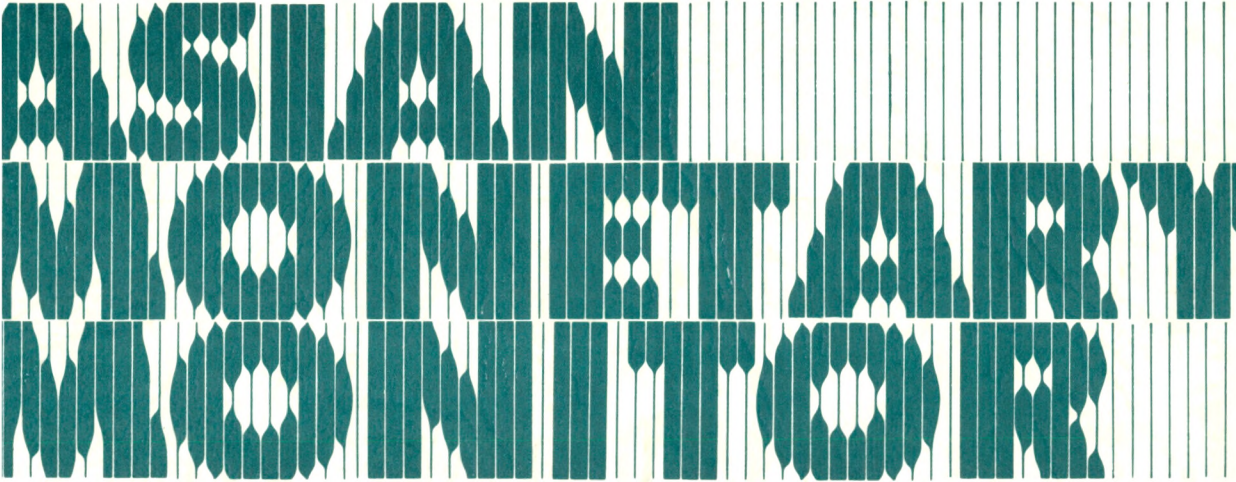
PAKISTAN: MONEY MARKET AND BALANCE OF PAYMENTS



PAKISTAN: MONEY, OUTPUT, GOODS AND ASSET PRICES







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REGIONAL SURVEY THE PROSPECTS FOR ASIAN EXPORTS

Introduction

This article employs established econometric techniques to explore export prospects in a number of Asian countries in 1995. The first section of the article, which summarises our results, methodology, and discusses conceptual issues, is followed by an Annex including more detailed results for individual countries. The relatively poor results obtained for Indonesia, using the model specification below, have been omitted from this survey; owing mainly to the complexities of modelling Indonesia's oil and commodity-based export sector, against the backdrop of its heavily managed exchange rate regime.

Summary of Forecasts

The forecasts on table 1 suggest that export growth in each of the six countries surveyed will be between 20-30% by December 1995. In most cases, assuming little change in economic activity overseas, export activity shows some moderation by year-end as a lagged response to exchange rate appreciation in 1994. Nevertheless, as shown in the charts within the Annex, export growth at between 20-30% in 1995 would be strong from a historical perspective.

TABLE 1
EXPORT GROWTH IN 1995

%YoY	Actual	Forecast (Dec.1995)
S. Korea	34.2 (May 1995)	22.8 (+)
Malaysia	38.6 (Feb. 1995)	26.8
Philippines	34.4 (Apr. 1995)	20.4 (+)
Singapore	34.0 (Apr. 1995)	31.3 (revised to 25.0%-see annex)
Taiwan	25.5 (Mar. 1995)	22.8 (+)
Thailand	28.4 (Apr. 1995)	24.7

(+) probably stronger

Regression Results

Except in Singapore, both the real effective exchange rate (REER), and the growth of imports in major export markets, as shown in table 2, proved to be statistically significant and with the correct signs.

TABLE 2
REGRESSION RESULTS

	Constant % yoy	Sensitivity to yoy import growth in key export markets (1)	Sensitivity to yoy change in Real Effective Exchange rate (2)	Time lag associated with exchange rate effect (months)	% change in export growth explained* by (1) and (2)
S. Korea	3.99	0.948	-0.633	12	61
Malaysia	3.67	1.708	-0.177	12	55
Philippines	-0.29	1.515	-0.180	12	67
Singapore	0.67	3.257	Nil	-	79
Taiwan	3.39	1.389	-0.813	12	63
Thailand	9.01	1.285	-0.675	24	58

* Adjusted R²

Perhaps unsurprisingly, growth of imports in major export markets and the lagged REER explain much more than 50% of the growth in exports in all of the countries surveyed. On the whole, sensitivity to the import growth variable, as opposed to exchange rates, is much greater and of similar magnitude for most of the countries, except in Singapore where sensitivity to overseas growth is unusually high. In each case, the exchange rate impacts on exports over a twelve month period, except in Thailand where the lag is much longer.

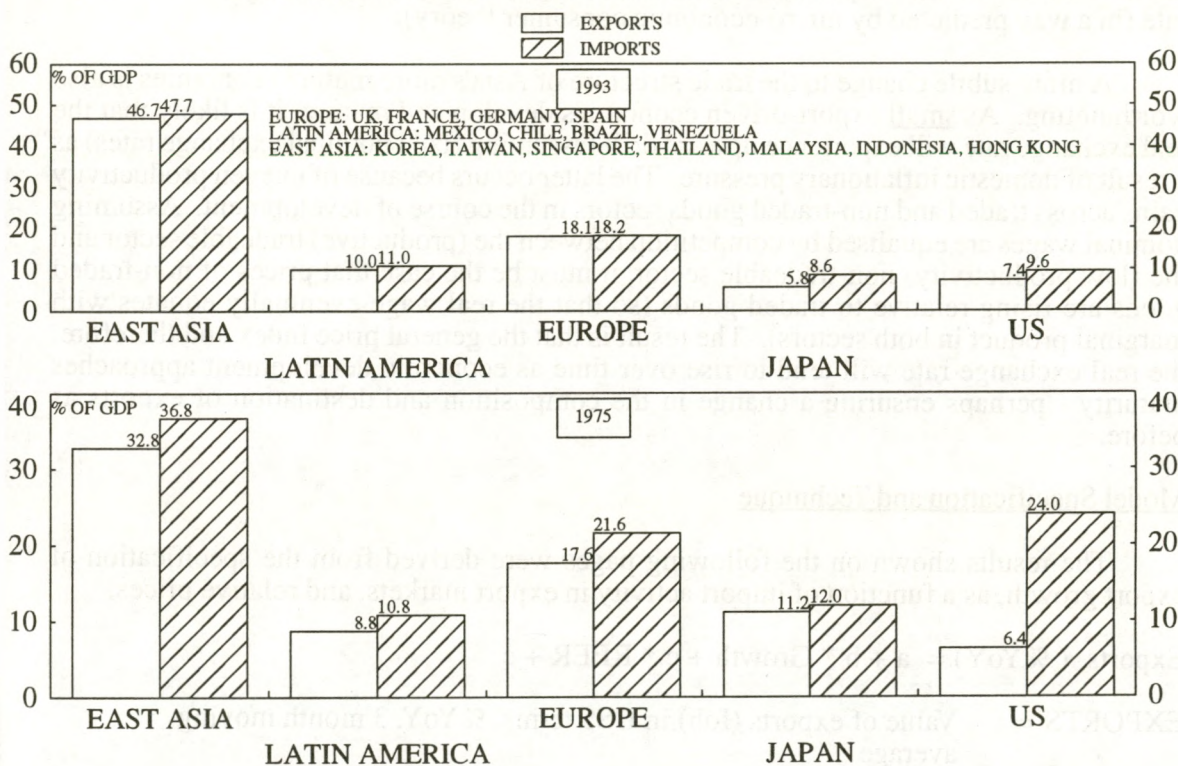
Since most S.E. Asian currencies remain linked to the US dollar through broadly fixed exchange rate regimes, they have gained considerable competitive advantage in 1995 so far from the dollar's precipitous fall, especially against the Yen. However, as suggested by Table 2 above, the boost from this factor in 1996 is likely to be small in magnitude by comparison with any effects arising from major changes, later this year, in import demand from overseas.

The relative importance of such price and income effects has been a subject of much debate in trade theory and corresponding econometric analysis. The body of evidence is consistent with our results, which suggest that while exports respond almost immediately to changes in overseas income, the response to price changes can be protracted and slow. This is consistent with profit maximising, rational, consumer behaviour to the extent that changing supplier entails costs, financial and otherwise. Thus switching supplier will only be worthwhile if price changes are perceived to be permanent and significant over the consumer's planning horizon. The slow adjustment of export volumes to price changes also gives rise to the so-called "J-curve" phenomenon. As exports are typically invoiced in the country's own currency, and some time ahead of delivery date, the immediate impact of a devaluation, for instance, is to reduce the value of outstanding exports; a seemingly perverse result, which highlights the importance of correctly incorporating appropriate exchange rate lags within export models.

Growth and Liquidity

Chart 1 serves to highlight the importance of exports to GDP growth in East Asia. On a global comparison, East Asian exports have obviously contributed the lions share to regional GDP with indications that this sector has been growing in relative importance over eighteen years to end-1993.

REGIONAL SURVEY: CHART 1
COMPONENTS OF NATIONAL ACCOUNTS AS % OF GDP



Given its contribution to national income generation, it should not be surprising then to find that export receipts have also exerted a significant influence on domestic liquidity conditions within East Asia. Arguably, speculative flows attracted to some of the region's growing and maturing capital markets are now much more significant, but this observation ignores, inter-alia, the explosive growth of trade finance related activity; which remains a core function for many of Asia's banks, and also a key influence on local money market interest rates. In Thailand, for instance, export bills outstanding on banks balance sheets were Baht 163bn at end-December 1994 (US\$ 6.5bn), or around 4% of banks total assets. As a result, Thai overnight interest rates are acutely sensitive to exporters' hedging activities, especially amid expectations of an appreciation of the domestic currency. Of course the relationships between trade flows and domestic financial conditions extend far beyond export sector growth alone, and should be viewed more in the context of broader balance of payments flows and existing exchange rate regimes. When set against Asia's mostly fixed or highly managed exchange rates, export growth has undeniably exercised a significant influence on domestic liquidity conditions, mainly through the operations of unsterilised foreign exchange intervention and foreign currency reserves accumulation.

Structural Shifts

Clearly export growth trends are crucial for gauging economic activity and financial conditions in Asia although econometric forecasting of these trends is hazardous in the midst of rapid structural change. Such change will diminish or enhance the significance of key variables in the model over time, thus potentially rendering the model unstable for forecasting purposes. A shift in the composition of exports as a result of secular exchange rate trends is an obvious example of structural change which has affected the region periodically. The substantial relocation of production activity out of Japan and into the rest of Asia, as a result of prolonged Yen strength, is likely to be at least one factor affecting both the product composition of the export base and the relative importance of export destinations. This in turn has implications for the sensitivity of export demand to the exchange rate (in a way predicted by micro-economic consumer theory).

A more subtle change to the trade structure of Asia's more mature economies is also worth noting. As small export-driven economies develop and mature, it is likely that the real exchange rate will experience upward drift (assuming fixed nominal exchange rates) as a result of domestic inflationary pressure. The latter occurs because of uneven productivity gains across traded and non-traded goods sectors in the course of development. Assuming nominal wages are equalised by competition between the (productive) tradeable sector and the (low productivity) non-tradeable sector, it must be the case that prices of non-traded goods are rising relative to traded goods (so that the real wage eventually equates with marginal product in both sectors). The result is that the general price index and therefore, the real exchange rate will tend to rise over time as economic development approaches maturity - perhaps ensuring a change in the composition and destination of exports as before.

Model Specification and Technique

The results shown on the following pages were derived from the specification of export growth, as a function of import activity in export markets, and relative prices:

$$\text{Exports (\%YoY)} = a + b * \text{Growth} + c * \text{REER} + e$$

EXPORTS = Value of exports (fob) in US\$ terms, %YoY, 3 month moving average

a = Constant term, % yoy

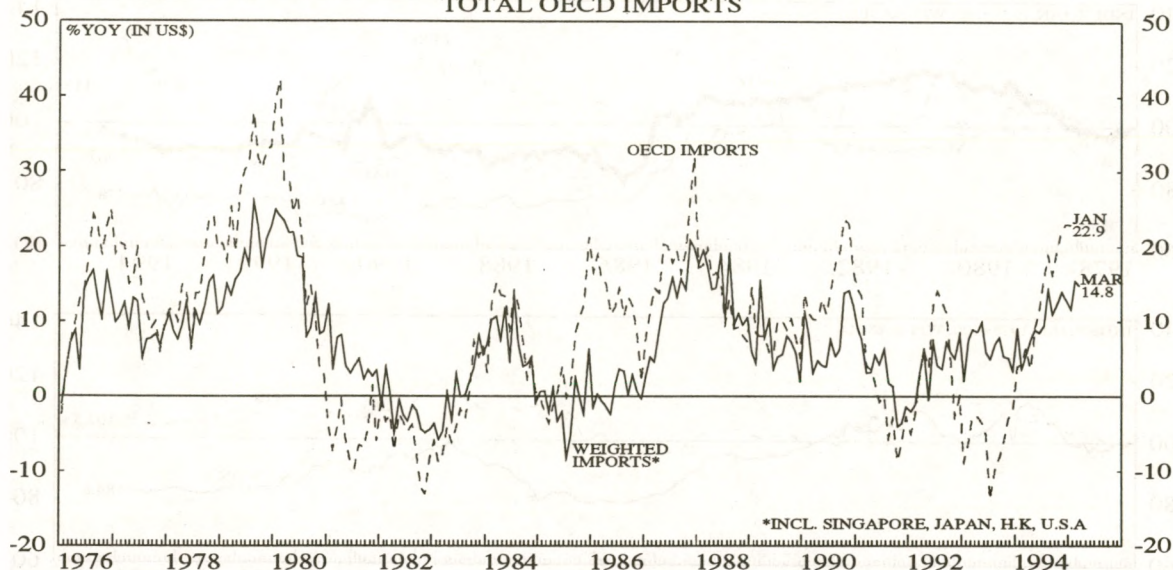
GROWTH = Weighted average of import growth in US\$ terms (cif) in major export destinations, %YoY, 3 month moving average

REER = Real Effective Exchange Rate (lagged appropriately), %YoY 3 month moving average

e = Stochastic error term

The above specification provided better results overall than the log-linear form commonly used in econometric estimation. In practise, results are acutely sensitive to slight changes in the model specification, although with no one functional form producing consistently good results across all countries. Of the number of different versions tried, the above specification was chosen both for its conceptual purity and high explanatory power. A robust weighted least squares technique was used so that outlying observations would not unduly distort the estimation process.

REGIONAL SURVEY: CHART 2
MALAYSIA: WEIGHTED IMPORTS OF MAJOR EXPORT DESTINATIONS AND
TOTAL OECD IMPORTS



The Data

For all countries surveyed, the growth of monthly exports, value in US dollar terms, was fitted against an appropriate proxy for import growth in major export destinations, and a real effective exchange rate using moving trade weights.

Import growth was defined as:

$$\sum_{i=1}^n a_{ij} * G_j$$

a_{ij} = percentage of country i 's exports (value) imported by country j

G_j = year-on-year percentage change in country j 's total imports

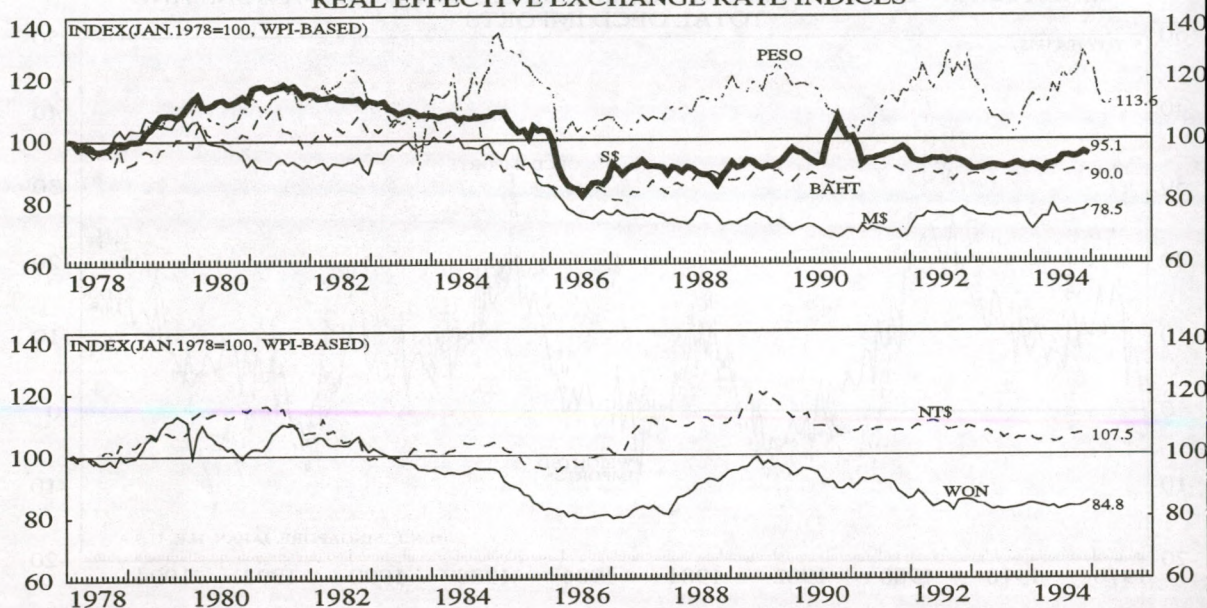
n = number of countries surveyed

Data in most cases range from January 1977 to the latest available observation at the time of writing, mostly in 1995.

For illustrative purposes, Chart 2 above plots the weighted import growth for Malaysia. The corresponding path for export market growth for other economies in this survey is, not surprisingly, similar to that shown above; indicating broad similarity in the country composition of Asian exports. The chart above also compares our import growth proxy with the growth in total OECD imports, in US\$ terms, indicating the extent to which Intra-Asian exports have grown in importance during the 1990s and also reflecting the relative importance of those economies within the OECD as export destinations.

There are obvious difficulties in drawing firm conclusions about competitiveness from the REERs in Chart 3. These relate mainly to the choice of base year and assumptions about the strength of relative Purchasing Power Parity (a thorough discussion of the methodology used in computing REERs, and the conceptual difficulties can be found in AMM Vol. 16 No. 4 and AMM Vol. 17 No. 5). Nevertheless, looking over the past five years, it is worth observing that most currencies, except perhaps the Philippines peso have remained competitive and stable when compared with their 1978 levels.

REGIONAL SURVEY: CHART 3
REAL EFFECTIVE EXCHANGE RATE INDICES



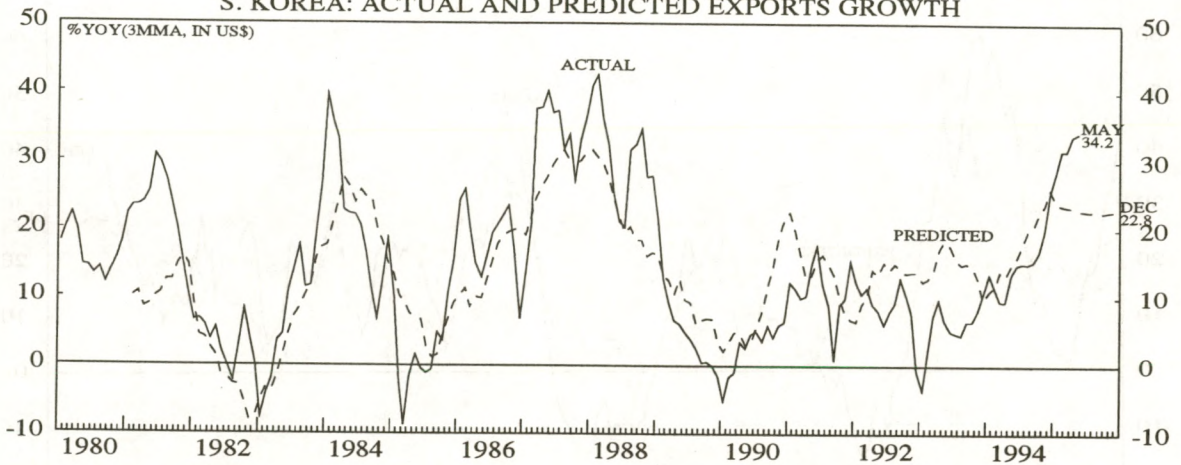
Key Forecast Assumptions

Projections for Asian exports derived from these models are most useful in gauging the direction of change, and its broad magnitude, rather than any precise figure for export growth. This is partly because of the difficulties in capturing structural change, as discussed above but also owing to a number of assumptions which are made for forecast purposes. The import growth variable was assumed to remain steady throughout 1995 at the latest available figure (for instance 14.8% for Malaysia, the March observation); while the REER was estimated until December 1994, in cases where the actual data were not available. Therefore, given our assumptions about stable growth in export markets, the projections for 1995 are reflecting mainly the effects of REER movements from January 1994 to December 1994.

SUMMARY AND CONCLUSIONS: The econometric models discussed above, and depicted in the annex to this article, suggest that export growth in the six countries surveyed is likely to remain strong during 1995 (and possibly beyond, into 1996, as benefit is derived from Yen strength so far). This is likely to have positive implications for growth and liquidity in the region. Assuming stability in the rate of import expansion in major export markets, the lagged effect of exchange appreciation across Asia last year will have a modest dampening effect. Nevertheless, exports are predicted to grow at around 20-30% across all of the countries surveyed. The results also suggest that the sensitivity of exports to policy variables such as the exchange rate is diminishing. In Malaysia, for instance, the REER variable was relatively insignificant; possibly highlighting a structural shift in recent years in the direction of higher productivity exports (such as in Singapore). Econometric forecasting of this nature is generally hazardous during phases of major structural change although the relatively muted impact from exchange rates implied by these models suggests that our conclusions remain robust if relatively stable import growth in Asia's major export markets is maintained this year.

ANNEX

REGIONAL SURVEY: CHART 4
S. KOREA: ACTUAL AND PREDICTED EXPORTS GROWTH



$$\begin{aligned}
 \text{Exports (\% yoy)} &= 3.997 + 0.948 * \text{Growth} - 0.633 * \text{REER} \\
 \text{Weighted t values} &= (58.9) \quad (170.6) \quad (-84.1) \\
 \text{Weighted Adj. R}^2 &= 0.614
 \end{aligned}$$

Major export destinations

US	38.0%
Japan	24.5%
Hong Kong	13.6%
Germany	7.6%
Singapore	6.6%
Taiwan	4.8%
Indonesia	4.4%
Total of above	99.5%

Major exports

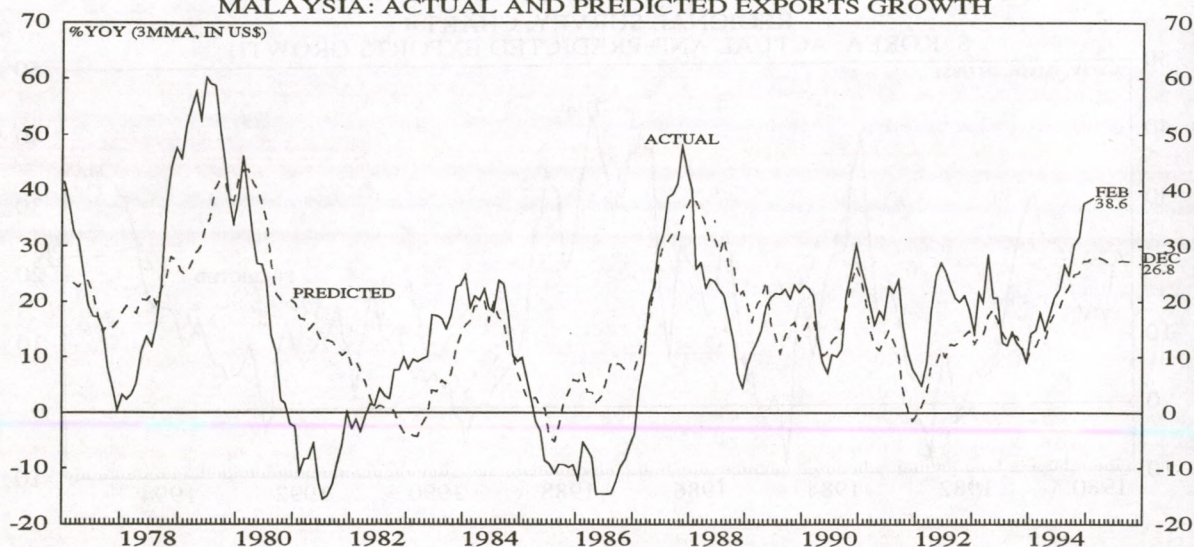
	1989	1994
Total (US\$bn, fob)	62.4	96.0
Shipping	2.9%	5.2%
Steel	3.8%	3.4%
Fabrics	5.1%	5.7%
Cars	3.3%	4.7%
Semiconductors	7.5%	12.3%
Telecom. Eqpt.	2.8%	3.8%
Chemicals	0.9%	2.2%
Total of above	26.3%	37.3%

Source: Bank of Korea, Monthly Statistical Bulletin, March 1995

Comments:

The large and significant constant term suggests missing variables although the fit is not improved by the inclusion of other proxies such as growth in productive potential. Besides any impact from the exchange rate, and growth in export markets, S. Korean exports are highly sensitive to developments in the semiconductor and computer industries which continue to grow strongly. This structural element complicates the picture considerably. Nevertheless, it is likely that S. Korean exports generally have received a fillip from Yen strength and should continue grow at a healthy pace. S. Korea also continues to enjoy substantial investment within key industries albeit at the cost of higher inflation. A fuller discussion of Korean exports in an economic context may be found in AMM 1995 Vol. 19 No. 2.

REGIONAL SURVEY: CHART 5
MALAYSIA: ACTUAL AND PREDICTED EXPORTS GROWTH



$$\begin{aligned}
 \text{Exports (\% yoy)} &= 3.670 + 1.708 * \text{Growth} - 0.177 * \text{REER} \\
 \text{Weighted t values} &= (47.1) \quad (214.7) \quad (-21.0) \\
 \text{Weighted Adj. R}^2 &= 0.549
 \end{aligned}$$

Major export destinations

Singapore	21%
Japan	18%
US	17%
Hong Kong	3%
Total of above	59%

Major exports

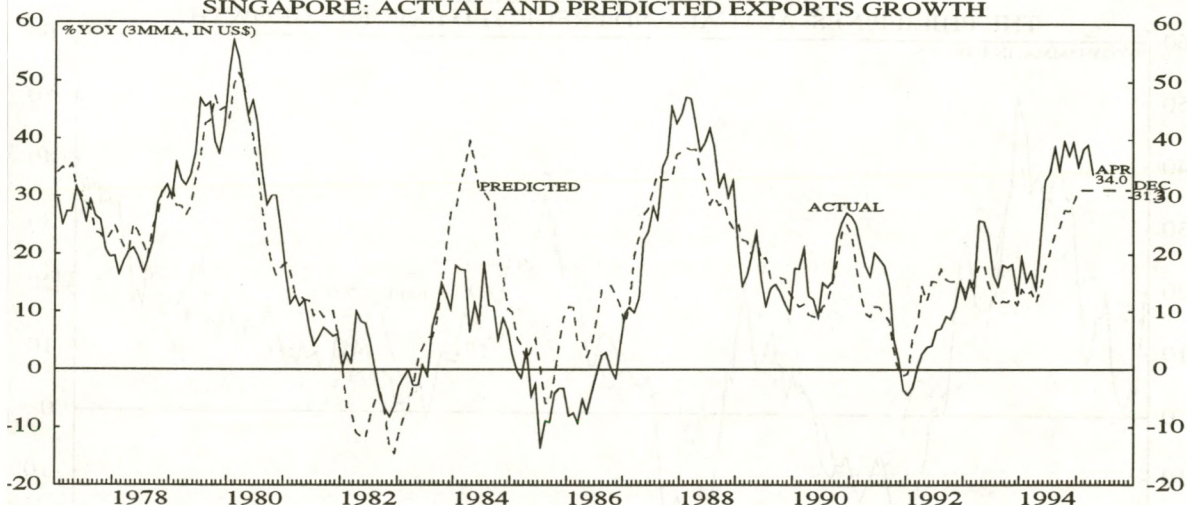
	1989	1993
Total (US\$ bn, fob)	25.0	47.1
Crude Materials	18.7%	9.1%
Fuels	16.2%	10.3%
Transport Eqpt.	32.4%	48.5%
Manufactures	8.4 %	9.6%
Misc. Manuf.	8.3%	10.3%
Total of above	84.0%	87.8%

Source: Monthly Statistical Bulletin, Dept. of Stats., Dec 1994

Comments:

As with Singapore, export growth in Malaysia is fairly insensitive to changes in the real effective exchange rate. However during the 1980s on a real effective basis the M\$ (as shown in Chart 3) depreciated by approximately 20-25%. This was accompanied by substantial industrial change within the economy and a radical metamorphosis in the composition of its exports. In the early 1980s its exports were dominated by primary goods (which in 1984 accounted for around 45% of the total). Over the next 10 years the country industrialised and the share of manufactured goods exported rose from 33% to between 60-75%. Today, like Singapore, Malaysia is riding a similar semi conductor driven wave of export demand. Given a continuation of the industrial relocation across Asia and of buoyant demand for Malaysian exports in its major markets, in the year ahead export growth is likely to remain vigorous, contributing to upward pressure on the M\$/US\$ exchange rate.

REGIONAL SURVEY: CHART 6
SINGAPORE: ACTUAL AND PREDICTED EXPORTS GROWTH



Exports (% yoy) = $0.675 + 3.257 * \text{Growth}$
 Weighted t values = (11.8) (381.8)
 Weighted Adj. R² = 0.789

Major export destinations

Malaysia	20%
US	18%
Hong Kong	9%
Japan	7%
Thailand	5%
Total of above	59%

Major Exports

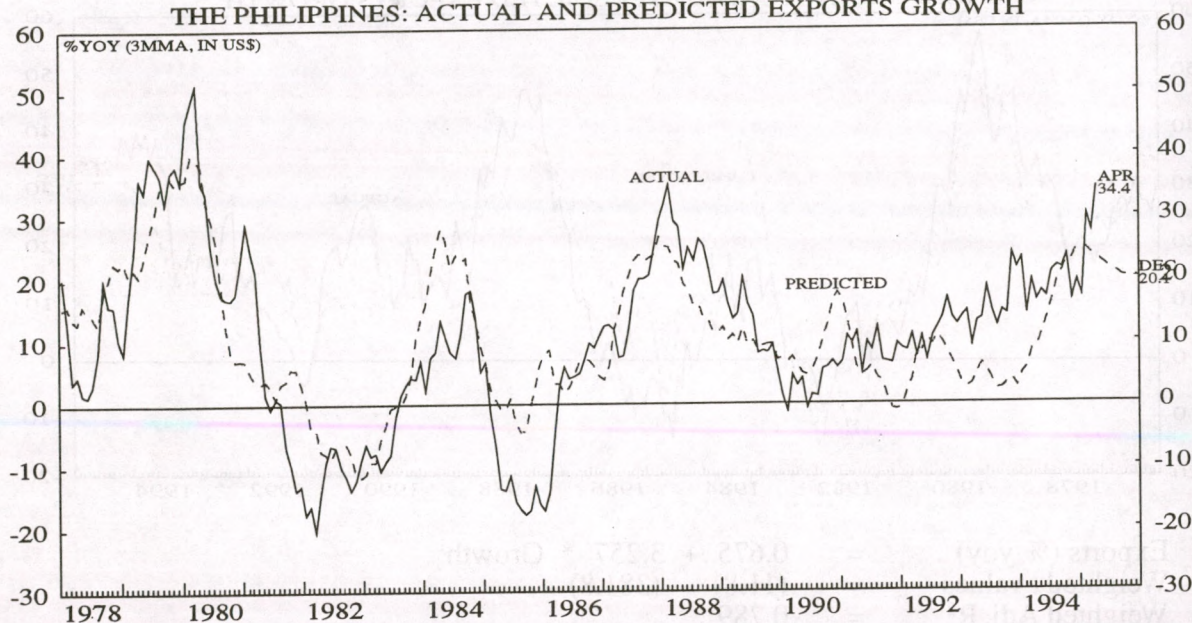
	1990	1994
Total (US\$bn,fob)	52.5	96.5
Mach. & Transport	50.1%	63.9%
Mineral Fuels	18.1%	9.6%
Manufactures	7.0%	6.0%
Chem/Chem products	6.3%	5.7%
Total of above	81.5%	85.2%

Source: Monthly Digest of Statistics (Feb. 1995)

Comments:

A rush to register exports before changes to the General Sales Tax (GST) in April 1994 and an improvement in the recording of exports, contributed to the torrid pace of export growth in 1994 and early 1995. It is likely, therefore, that 1995 will see some moderation in export activity. Demand for semi-conductor related goods lies behind much of the growth in exports from 1992 to present day. While much of this demand originated from Asia ex-Japan, the US accounts for a sizeable percentage. This demand has partly been responsible for the strength in the S\$/US\$ (the authorities have successfully engineered a stronger S\$/US\$ on previous occasions as a counter inflationary policy). Although the S\$ has appreciated around 25% against the US\$ since 1990, it has lost around 22% to the Yen over this time. However, it has remained relatively stable on the real effective exchange rate illustrated in Chart 3 since the late 1980s (excluding the abrupt appreciation in 1990). Perhaps the export model for this country shows most clearly how dominant an influence the "income effect" is over exports when compared with the "price effect" which for Singapore appears negligible.

REGIONAL SURVEY: CHART 7
THE PHILIPPINES: ACTUAL AND PREDICTED EXPORTS GROWTH



$$\begin{aligned}
 \text{Exports (\% yoy)} &= -0.297 + 1.515 * \text{Growth} - 0.180 * \text{REER} \\
 \text{Weighted t values} &= (-4.782) \quad (245.6) \quad (-36.96) \\
 \text{Weighted Adj. R}^2 &= 0.671
 \end{aligned}$$

Major export destinations

US	36%
Singapore	30%
Japan	19%
Germany	8%
Hong Kong	4%

Total of above 97%

Major exports at end-1994

Total (US\$ bn, fob)	13.4
Coconut oil	3.5%
Semi-Conductors	13.7%
Micro-circuits	5.9%
Other Electronic	6.3%
Clothing	17.6%
Woodcraft	2.7%

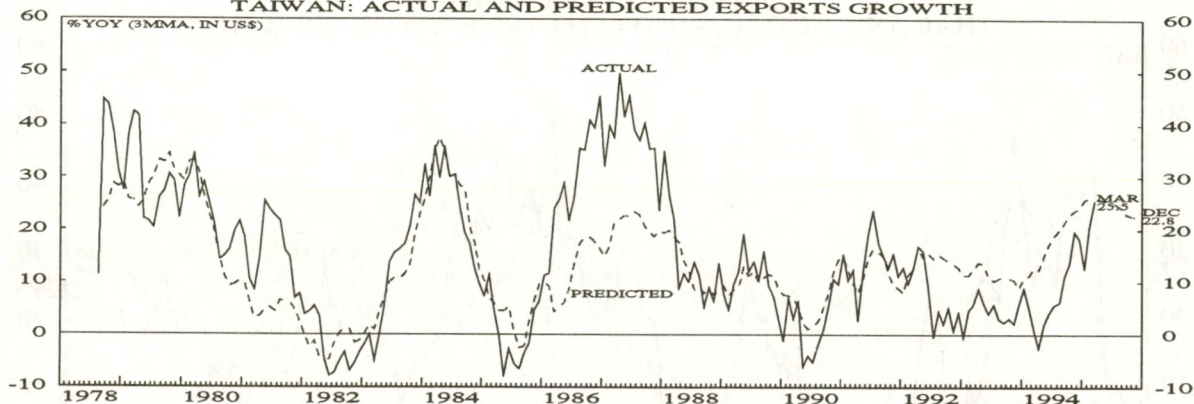
Total of above 49.7%

Source: Economic Indicators - BSCB (Jan 1995)

Comments:

The sharp slowdown in export growth depicted in the chart above reflects the negative effects of last year's sharp appreciation of the peso. On a Purchasing Power Parity basis, the peso remains overvalued although any negative impact arising from this factor should be outweighed by productivity gains associated with the rapid pace of investment activity. The Philippines is in the early phases of a new growth and product cycle; the prospects for export growth are therefore bright given her relatively skilled workforce and open capital account.

REGIONAL SURVEY: CHART 8
TAIWAN: ACTUAL AND PREDICTED EXPORTS GROWTH



$$\begin{aligned} \text{Exports (\% yoy)} &= 3.386 + 1.389 * \text{Growth} - 0.813 * \text{REER} \\ \text{Weighted t values} &= (53.2) \quad (213.7) \quad (-105.5) \\ \text{Weighted Adj. R}^2 &= 0.630 \end{aligned}$$

Major Export destinations

US	27%
Hongkong	22%
Japan	11%
Singapore	3%

Total of above 63%

Major Exports

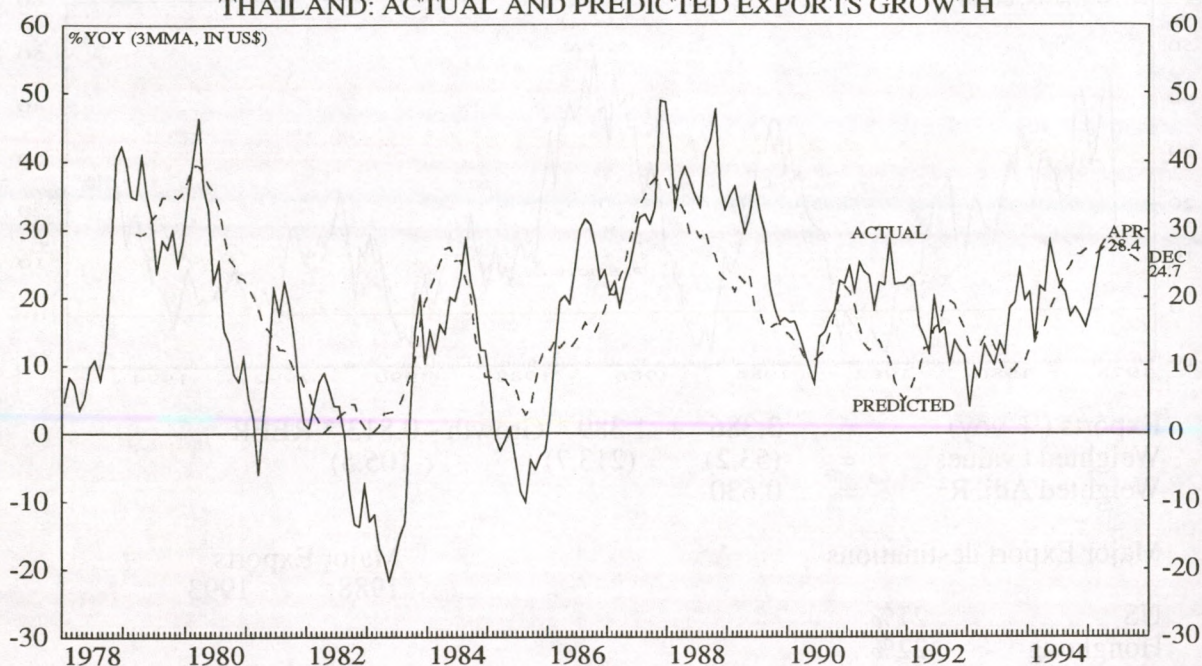
	1988	1993
Total (US\$bn, fob)	67.7	84.9
Plastics	5.5%	5.9%
Machinery	14.3%	19.5%
Electrical	16.6%	19.2%
Footwear	6.4%	3.2%
Textiles	6.1%	5.3%
Others	12.6%	9.6%
Total of above	61.5%	62.7%

Sources: Industry of Free China, CEPD, Vol LXXXIII No. 2, FIN. STATS-April 1995

Comments:

Chart 3 shows that since 1990 the real effective exchange rate of the NT\$ has been relatively stable, when compared with the early or late 1980s. This masks a 40% depreciation (approximately) against the Japanese Yen over that time, a clear advantage for Taiwanese exporters vis-a-vis their Japanese counterparts. Running parallel to Japanese investment (and relocation) to Taiwan, has been the migration of lower technology industry to cheaper cost bases elsewhere in Asia, especially China. Evidence consistent with this is the rise in the proportion of exports to Hong Kong which were around 12% in 1990, but are closer to 22% today. By contrast Taiwan exports less, directly to the US: more being funnelled to Asia, possibly indirectly satisfying US end user demand. As might be expected its export product base is changing composition. Machinery and electrical equipment account for around 41% of the total today as opposed to 33% in 1990. Food and textiles are on the decline as foreign purchasers find it cheaper to source these goods from China or Indonesia which have gained in currency competitiveness (for instance the NT\$ has appreciated almost 30% against the Indonesian Rupiah since 1990).

REGIONAL SURVEY: CHART 9
THAILAND: ACTUAL AND PREDICTED EXPORTS GROWTH



$$\begin{aligned} \text{Exports (\% yoy)} &= 9.005 + 1.285 * \text{GROWTH} - 0.675 * \text{REER} \\ \text{Weighted t values} &= (122.05) \quad (143.2) \quad (-65.6) \\ \text{Weighted Adj. R}^2 &= 0.585 \end{aligned}$$

Major export destinations

US	20%
Japan	16%
Singapore	9%
Germany	5%
Hong Kong	4%
UK	3%

Total of above 57%

Major Exports

	1989	1994
Total (US\$ bn, fob)	20.0	45.1
Textiles	14.3%	11.7%
Machinery	6.0%	10.4%
Electrical	13.9%	25.8%
Agricultural	23.0%	11.4%
Fisheries	5.5%	5.9%
Total of above	62.7%	65.2%

Source: Bank of Thailand, Monthly Bulletin, Jan + Feb 1995

Comments:

Alongside Korea, Thailand possesses one of the most broadly based export sectors in Asia, both geographically and in terms of product mix. The large constant term above is almost certainly reflecting the omission of other export destinations from the import growth variable. While the forecast for 24.7% growth in 1995 is coming from a high base in 1994, it is difficult in the current growth and exchange rate environment to shave 1995 estimates significantly below this mark.

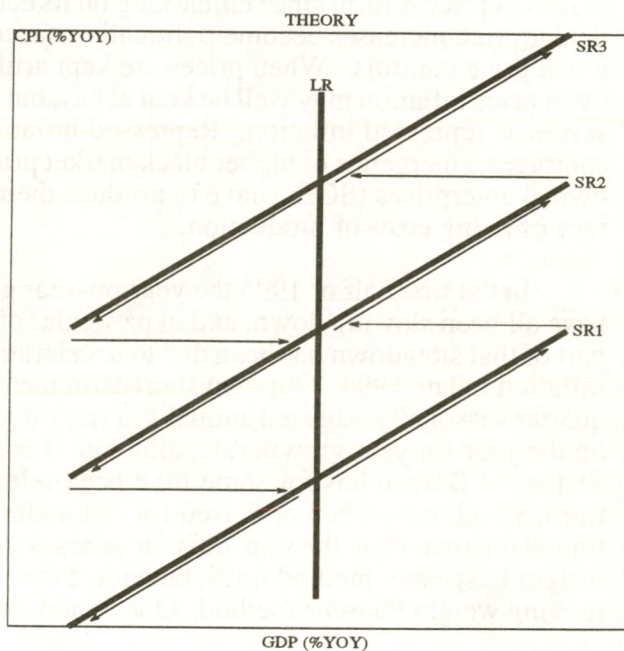
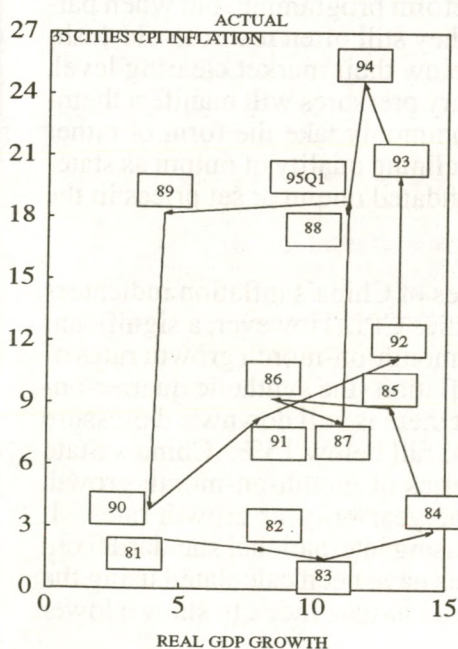
CHINA STATISTICAL HAZE HIDES GROWTH PATH

A year and a half ago, we argued that China was facing the prospect of a "hard landing now or harder landing later" (AMM November-December 1993). Since then we have argued that the authorities' intermittent attempts at monetary tightening have been insufficient to slow the economy to a pace consistent with decelerating (or at least non-accelerating) inflation, and that the authorities have procrastinated (and in certain cases reversed direction) on key measures of structural reform needed to facilitate the transition from a centrally planned to a more market based economic system, thus sweeping the structural problems under the carpet and putting off the day of reckoning. However, the continued resilience of China's reported economic growth rate and deceleration in the various inflation rates, in the face of overwhelming structural problems, appear to have miraculously defied economic theory's equivalent of Newton's law of gravity. The widespread view that China's economy is a miracle and will (or has already) become the world's next economic superpower, requires little rational explanation and only a modest leap of faith. On the other hand, careful analysis of the increasing amount of official Chinese statistics reveals plenty of data discrepancies, which can be used to undermine the miracle story and put just about anything else in its place.

The Expectations-Augmented Aggregate Supply Curve

One possible initial framework for looking at China's economy is the expectations-augmented aggregate supply curve, tracing out the long-term and short-term relationships between real economic growth and inflation. In the short term there may be a trade-off between growth and inflation, as indicated by the short-run aggregate supply curve SR1. However use of this trade-off (i.e. expanding output by expanding aggregate demand) depends on the resulting increase in inflation being unanticipated, i.e. on some degree of money illusion. As inflationary expectations adapt to a higher level of inflation, the short

CHINA: CHART 1
GDP GROWTH AND INFLATION



run aggregate supply curve shifts to the left to a new line (SR2) where the natural (non-accelerating inflation) rate of growth is compatible with the new expected rate of inflation. Any attempt by the authorities to keep output persistently above capacity will not just lead to inflation, but to ever accelerating rates of inflation as the short-run aggregate supply curve ratchets up to SR3 and beyond. In order to quell inflationary expectations, the authorities need to slow economic growth to below the natural rate for a credible period of time. Hence, in the long run there is no trade-off between growth and inflation, as signified by the long run aggregate supply curve LR being vertical at the natural (non-accelerating inflation) rate of growth.

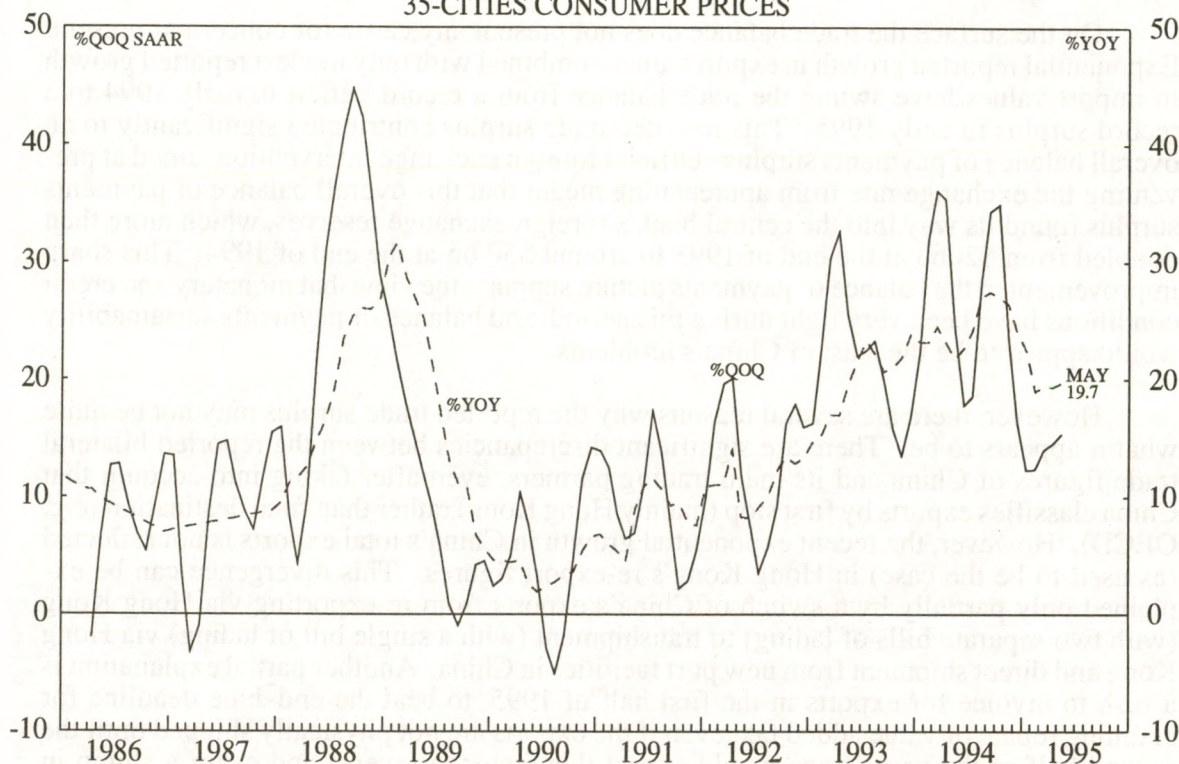
Looking at China, we see that the path of growth and inflation traces out several periods of attractive short-run trade-offs, such as in 1981-84, in 1985-87, and to a lesser extent (reflecting less adaptive more rational inflation expectations) in 1990 to 1992. In between we have seen intermittent ratcheting up of inflation expectations in 1985, 1988 and 1993-94, and the only time inflation expectations were brought down significantly was with a prolonged slowdown in 1989-90, accompanied by reimposition of price controls. On the surface, the official figures for the first quarter of 1995 suggest that the authorities have managed to dampen both actual and expected inflation without slowing the economy significantly. However, as we will discuss, it may be that inflation has been repressed rather than cured, and it may be that the output of the economy has slowed more significantly than the GDP figures suggest.

Inflation: Overt and Repressed

However, the use of the aggregate supply/demand framework for China's economy is limited by the continued role of the authorities in the determination of prices during the process of transition from a centrally planned economic system to a more market based one. Prices are not necessarily market clearing prices equilibrating the forces of demand and supply. Although prices become more market-determined as they are deregulated, they may still not reflect true opportunity cost given the continued prevalence of regulated prices and other distortions in related product and factor markets. China has made great strides in price reform since embarking on its economic reform programme, but when particular price increases become politically unacceptable, they still often resort to old-fashioned price controls. When prices are kept artificially below their market clearing level, overt price inflation may well be kept at bay, but inflationary pressures will manifest themselves as repressed inflation. Repressed inflation can commonly take the form of either shortages, emergence of higher black market prices, or declining quality of output as state-owned enterprises (SOEs) have to produce their plan-mandated output at set prices in the face of rising costs of production.

In the first half of 1995 the year-on-year growth rates of China's inflation indicators have all been slowing down, and in particular of the 35 cities CPI. However, a significant part of that slowdown has been due to deceleration in the month-on-month growth rates of inflation in late 1994. Our own short-term measure of inflation (the synthetic quarter-on-quarter seasonally adjusted annualised rate) suggests that there is still downward pressure on the year-on-year growth rate, although it is unlikely to fall below 15%. China's State Statistical Bureau has for some time been releasing a series of month-on-month growth rates, which have been criticised for not adding up to the year-on-year growth rates. It turned out that while the year-on-year series is calculated using international standard fixed weight Laspeyres methodology, the month-on-month rates have been calculated using the moving weight Paasche method. One would expect such a Paasche index to show a lower

CHINA: CHART 2
35-CITIES CONSUMER PRICES



inflation rate than a fixed-weight index as it captures the substitution effect of rational consumers switching from overpriced to underpriced goods - an effect which should not be captured as lower inflation.

Evidence of repressed inflation is hard to come by, but the authorities have on occasion released statistics on proportion of goods in adequate supply (around 80%, i.e. scarcities for around 20% of goods by official admission), and the proportion of goods meeting China's own quality standards (35-40%, i.e. 60-65% of goods fall short of China's own quality standards). Most of the evidence of repressed inflation is anecdotal, such as reports of the failure of agricultural commodity price stabilisation policies. In these cases, scarcities caused by price controls were exacerbated by farmers withholding produce from the market in anticipation (correct with hindsight) of eventual relaxation of price controls.

As China is opening up its doors to imports from the outside world, partly to alleviate shortages and partly to support its bid for WTO membership, world prices are increasingly becoming a factor in the domestic inflation picture, especially when domestic prices in certain instances rise above world prices. In theory, increased integration with the external sector and the convergence of domestic prices with international prices should lead to more efficient allocation of resources in China. The problem for China's authorities might be that without significant progress on restructuring the SOEs and allowing greater factor mobility into more productive sectors of the economy, the adjustment process may simply lead to an unaffordable import boom, which would eventually necessitate an inflationary devaluation.

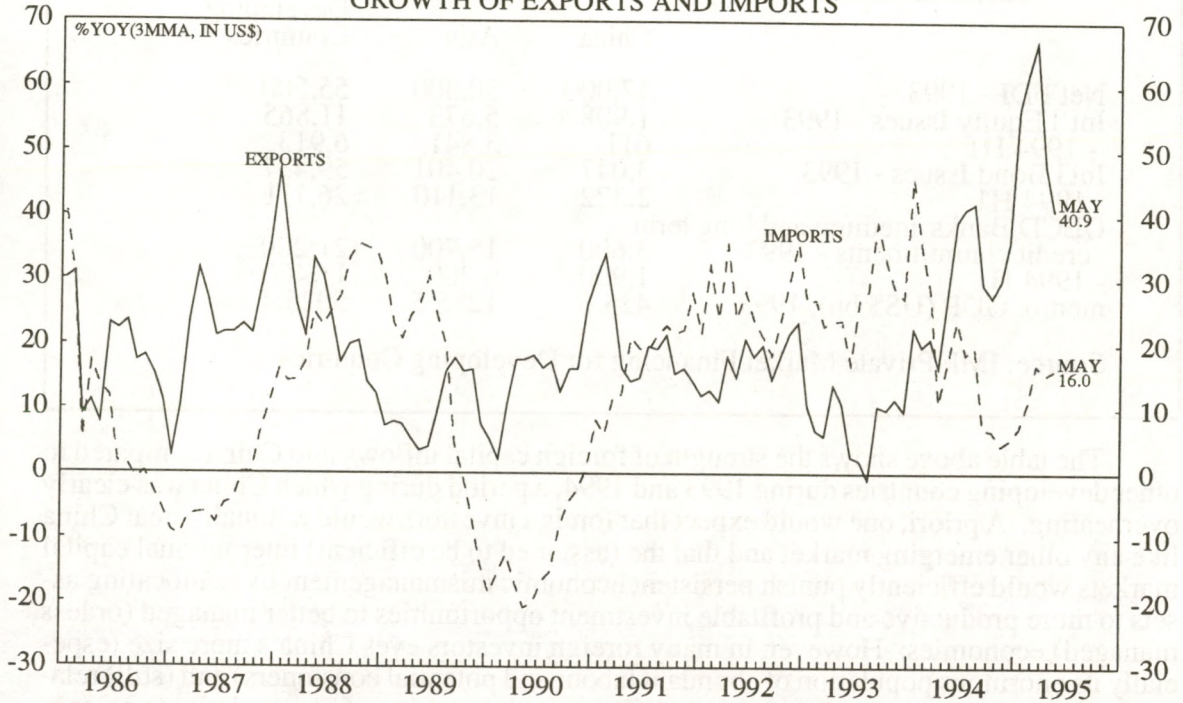
Balance of Payments Developments

On the surface the trade balance does not present any cause for concern at present. Exponential reported growth in export values combined with only modest reported growth in import values have swung the trade balance from a record deficit in early 1994 to a record surplus in early 1995. This reported trade surplus contributed significantly to an overall balance of payments surplus. Official foreign exchange intervention aimed at preventing the exchange rate from appreciating meant that this overall balance of payments surplus found its way into the central bank's foreign exchange reserves, which more than doubled from \$20bn at the end of 1993 to around \$50 bn at the end of 1994. This sharp improvement in the balance of payments picture supports the view that monetary and credit conditions have been very tight during this period, and balance of payments sustainability would appear to be the least of China's problems.

However, there are several reasons why the reported trade surplus may not be quite what it appears to be. There are significant discrepancies between the reported bilateral trade figures of China and its main trading partners, even after taking into account that China classifies exports by first stop (mainly Hong Kong) rather than final destination (e.g. OECD). However, the recent exponential growth in China's total exports is not reflected (as used to be the case) in Hong Kong's re-export figures. This divergence can be explained only partially by a switch of China's exports from re-exporting via Hong Kong (with two separate bills of lading) to transshipment (with a single bill of lading) via Hong Kong and direct shipment from new port facilities in China. Another partial explanation is a rush to invoice for exports in the first half of 1995, to beat the end-June deadline for claiming rebate of value added tax, even if the exports are not physically shipped until the second half of the year -- one would expect this factor to reverse and cause a slump in exports in the second half of 1995. Another plausible explanation is that the reported increase in the value of exports is more reflective of a sharp increase in the reported pricing of exports than in the actual volume of exports shipped (indeed, reported shipping volumes have declined).

Given the continued existence of exchange controls in China, there is plenty of reason to suspect that a significant proportion of the trade flows and the errors and omissions on the balance of payments are in fact disguised capital inflows. It has been widely suspected that during periods of rapid growth Chinese entities have underinvoiced exports to Hong Kong and booked profits in Hong Kong affiliates through transfer pricing. Conversely one would expect that during periods of tight credit conditions Chinese entities would have less profits to park in Hong Kong through underinvoicing, and might even have to overinvoice their exports to repatriate savings in order to meet domestic spending needs. A similar phenomenon may be occurring on imports, where China has in the past accused foreign investors of overpricing imports by joint-venture companies of second-hand machinery and intermediate goods. When joint ventures are squeezed by tight credit one would expect them to drive a harder bargain with their foreign partners, possibly to the extent of effectively getting recapitalised through underinvoicing of imports from the foreign partner. Besides the cash needs of credit-squeezed Chinese enterprises, the high and subsidised deposit rates and government bond yields have probably also induced significant (if illegal) capital inflows from those prepared to bet that the interest rate premium outweighs the exchange rate risk. However these distortions on the trade balance are only part of the capital inflows that have so far helped sustain China's economy.

CHINA: CHART 3
GROWTH OF EXPORTS AND IMPORTS



CHINA: CHART 4
FOREIGN EXCHANGE RESERVES AND TRADE BALANCE

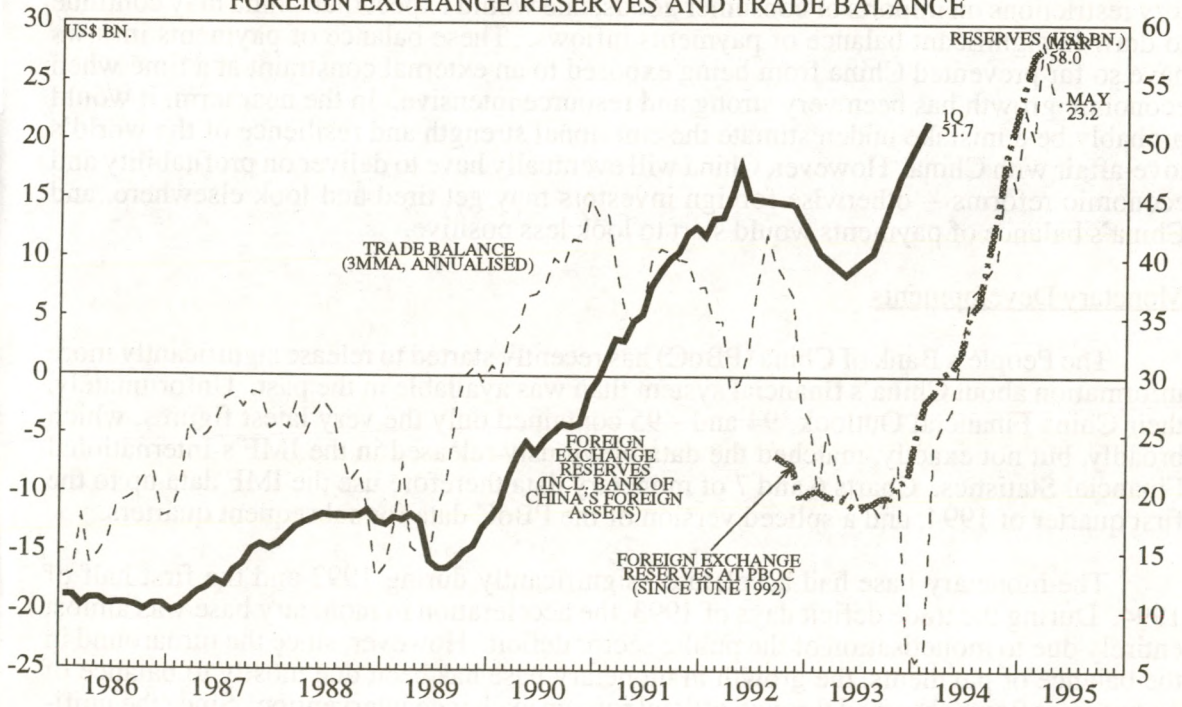


Table 1: China's share of foreign investment inflows

	China	Asia	Developing Countries
Net FDI - 1993	17,000	30,300	55,500
Int'l Equity Issues - 1993	1,908	5,673	11,865
- 1994 H1	611	3,841	6,913
Int'l Bond Issues - 1993	3,047	20,401	59,437
- 1994 H1	2,372	13,110	26,111
OECD Banks' medium and long term credit commitments - 1993	3,600	15,700	21,200
- 1994 H1	1,900	9,200	11,400
memo: GDP (US\$ bn), 1993	425.6	1285.5	5025.4

Source: IMF Private Market Financing for Developing Countries

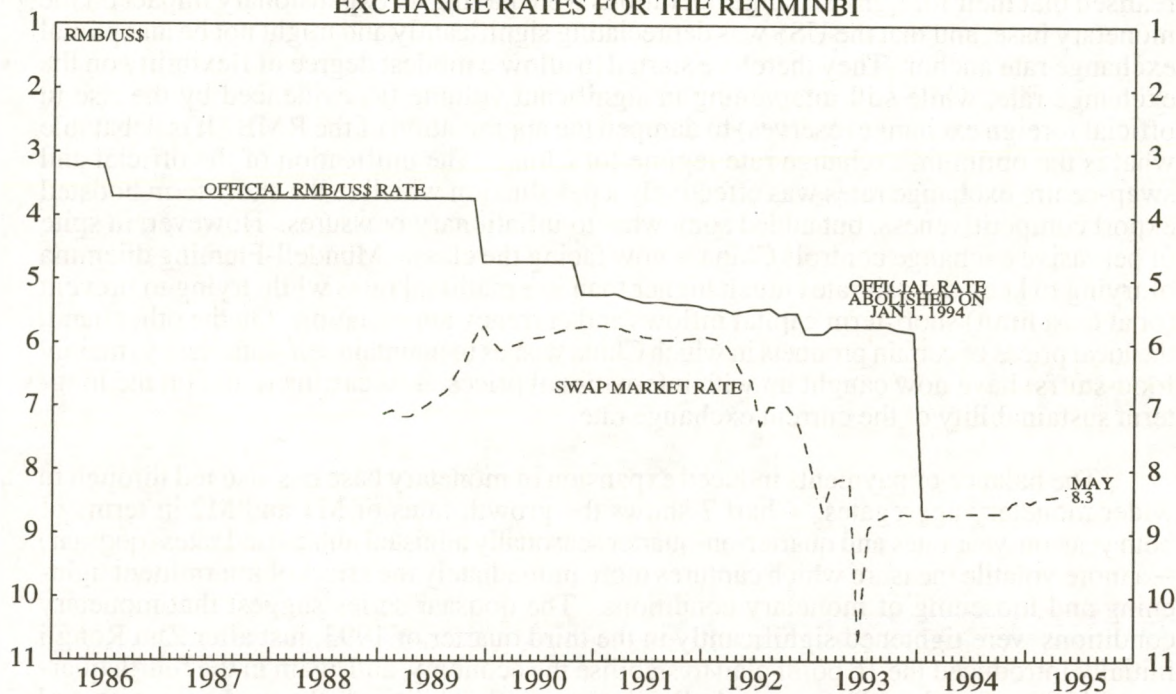
The table above shows the strength of foreign capital inflows into China compared to other developing countries during 1993 and 1994, a period during which China was clearly overheating. A priori, one would expect that foreign investors would rationally treat China like any other emerging market and that the (assumed to be efficient) international capital markets would efficiently punish persistent economic mismanagement by reallocating assets to more productive and profitable investment opportunities in better managed (or less managed) economies. However, in many foreign investors eyes China's mere size (especially its enormous population of abundant labour and potential consumers) and (still) relatively low foreign debt burden makes it different and deserving of greater latitude on economic policy direction. Indeed, China managed to raise most of this international capital relatively cheaply, with sovereign risk always priced at less than 100 bps above US Treasuries. Given the continued strength of the renminbi and the still heavy though discriminatory restrictions on imports of consumer goods, one would expect that China may continue to draw in significant balance of payments inflows. These balance of payments inflows have so far prevented China from being exposed to an external constraint at a time when economic growth has been very strong and resource intensive. In the near term, it would probably be a mistake underestimate the emotional strength and resilience of the world's love-affair with China. However, China will eventually have to deliver on profitability and economic reforms -- otherwise foreign investors may get tired and look elsewhere, and China's balance of payments would start to look less positive.

Monetary Developments

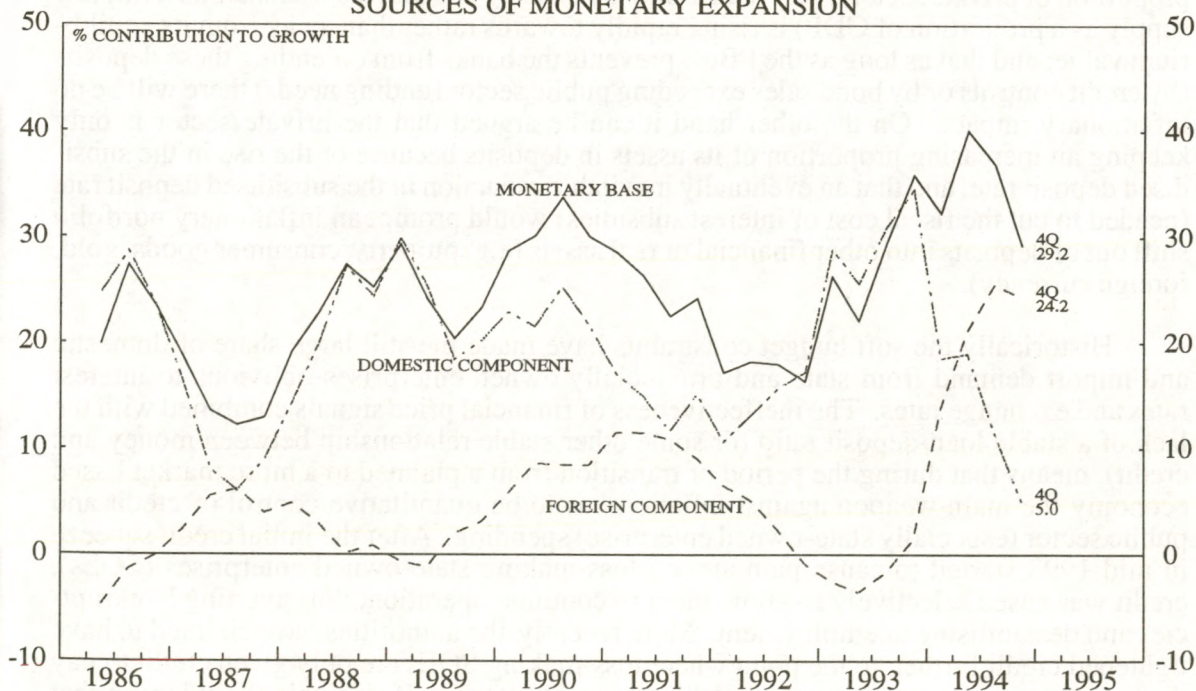
The People's Bank of China (PBoC) has recently started to release significantly more information about China's financial system than was available in the past. Unfortunately, their China Financial Outlook '94 and -'95 contained only the very latest figures, which broadly, but not exactly, matched the data previously released in the IMF's International Financial Statistics. Charts 6 and 7 of monetary data therefore use the IMF data up to the first quarter of 1994, and a spliced version of the PBoC data for subsequent quarters.

The monetary base had accelerated significantly during 1993 and the first half of 1994. During the trade deficit days of 1993, the acceleration in monetary base was almost entirely due to monetisation of the public sector deficit. However, since the turnaround in the balance of payments, the growth in monetary base has been due mostly to balance of payments inflows absorbed through official foreign exchange intervention. Since the unification of the official and swap-centre exchange rates at the beginning of 1994 the PBoC

CHINA: CHART 5
EXCHANGE RATES FOR THE RENMINBI



CHINA: CHART 6
SOURCES OF MONETARY EXPANSION

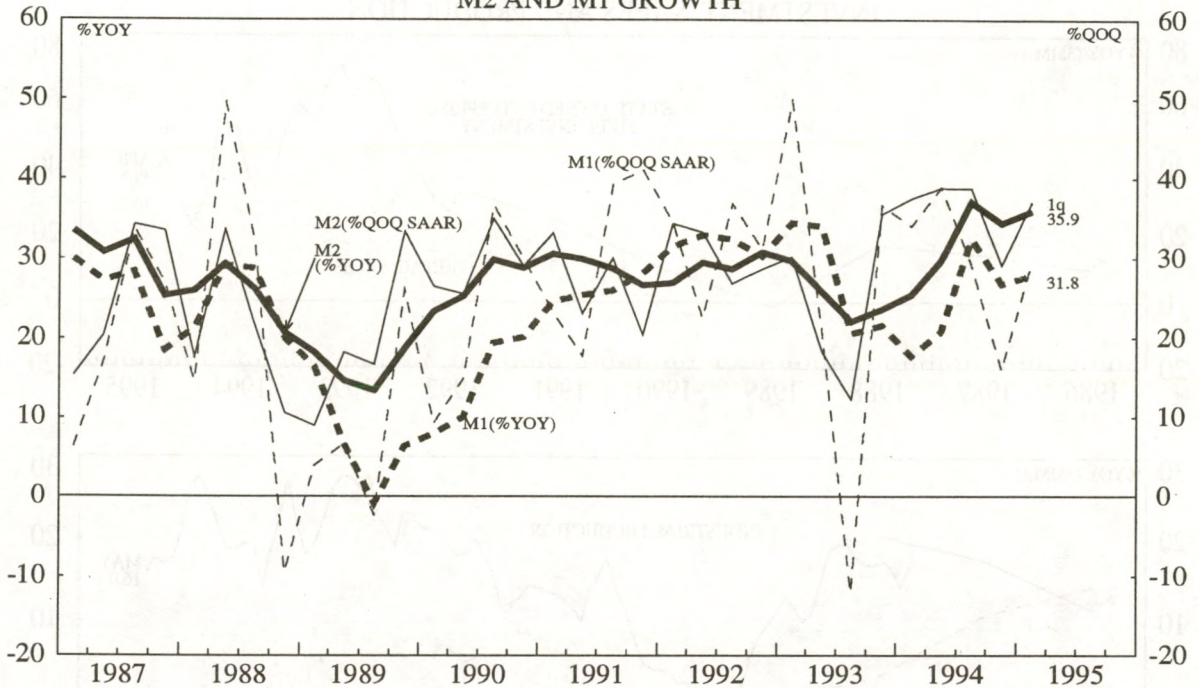


initially tried to keep the RMB/US\$ exchange rate fixed. However, by late 1994, they realised that their foreign exchange operations were having an expansionary impact on the monetary base, and that the US\$ was depreciating significantly and might not be an optimal exchange rate anchor. They therefore started to allow a modest degree of flexibility on the exchange rate, while still intervening in significant volume (as evidenced by the rise in official foreign exchange reserves) to dampen the appreciation of the RMB. It is debatable what is the optimum exchange rate regime for China. The unification of the official and swap-centre exchange rates was effectively a devaluation which in the short-term boosted export competitiveness, but added somewhat to inflationary pressures. However, in spite of pervasive exchange controls China is now facing the classic Mundell-Fleming dilemma of trying to keep deposit rates much higher than international rates while trying to prevent (or at least limit) short-term capital inflows and currency appreciation. On the other hand, the local prices of certain products in which China wishes to maintain self-sufficiency (mainly food-stuffs) have now caught up with international prices, thus casting doubt on the long-term sustainability of the current exchange rate.

The balance of payments induced expansion of monetary base has also fed through to wider monetary aggregates. Chart 7 shows the growth rates of M1 and M2 in terms of both year-on-year rates and quarter-on-quarter seasonally adjusted annualised rates (qoqsar) -- a more volatile measure which captures more immediately the effect of intermittent tightening and loosening of monetary conditions. The qoqsar series suggest that monetary conditions were tightened significantly in the third quarter of 1993, just after Zhu Rongji initially introduced the 16 point plan to stabilise the economy, and again in the fourth quarter of 1994, after the PBoC started allowing more flexibility on the exchange rate and imposed tighter control on credit. However, the money supply growth rates are still very high and would appear to be inconsistent with any significant deceleration in inflation. It can be argued that China is going through a period of financial deepening, i.e. that the proportion of private sector assets held as money is rising and that the Marshallian k (money supply as a proportion of GDP) is rising rapidly towards rather than away from its equilibrium value; and that as long as the PBoC prevents the banks from onlending these deposits (by credit controls or by bond sales exceeding public sector funding needs) there will be no inflationary impact. On the other hand it can be argued that the private sector is only keeping an increasing proportion of its assets in deposits because of the rise in the subsidised deposit rate; and that an eventually inevitable reduction in the subsidised deposit rate (needed to cut the fiscal cost of interest subsidies) would prompt an inflationary portfolio shift out of deposits into other financial or real assets (e.g. property, consumer goods, gold, foreign currency).

Historically the soft budget constraints have made the still large share of domestic and import demand from state and provincially owned enterprises oblivious to interest rates and exchange rates. The ineffectiveness of financial price signals combined with the lack of a stable loan-deposit ratio (or some other stable relationship between money and credit), means that during the period of transition from a planned to a more market based economy the main weapon against inflation has to be quantitative control of credit and public sector (especially state-owned enterprise) spending. After the initial credit squeeze in mid-1993 started to cause pain among loss-making state-owned enterprises (SOEs), credit was eased selectively to allow them to continue operation, thus averting bankruptcies and destabilising unemployment. More recently, the authorities have claimed to have tightened credit further, to the point where loss-making SOEs are only given credit to pay their workers, and not to invest in machinery or inventories. If true, this should mean that loss-making SOEs are making less direct claims on scarce resources, and thus reducing

CHINA: CHART 7
M2 AND M1 GROWTH



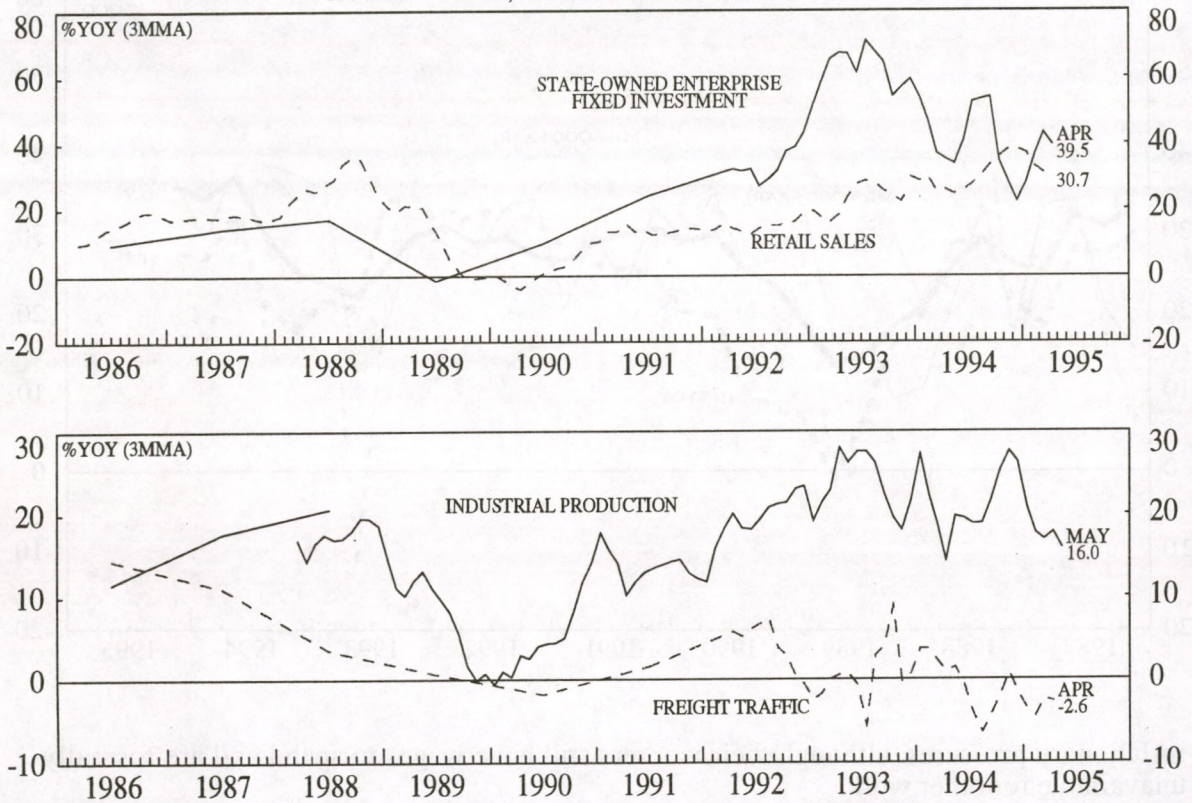
inflationary pressures, although their workers still have wages to spend and are formally unavailable for other work.

All in all, credit conditions are probably tight, but unevenly so, with some SOEs sufficiently important to override the implementation of the credit plan at local level, other enterprises suffering even tighter conditions as a result, and foreign funded enterprises able to circumvent the tight credit with foreign funding through the trade account. In a more market-based economic system, such 'selectivity' in credit allocation would be arbitrated away swiftly, but in a centrally planned economy selectivity is but a means of implementing the plan. However, China is still in transition between central planning and a socialist market economy, and has a system of undefined rules (with potentially harsh punishment for breaking them). In this system 'selectivity' may succeed in dampening output in the short run at the cost of exacerbating allocative inefficiencies by keeping alive SOE dinosaurs at the expense of killing more productive and efficient non-state enterprises.

A Real Economic Slowdown?

Although the evidence is mixed, on balance it appears that the unevenly tight credit policy has resulted in an uneven, but real economic slowdown. Fixed investment by SOEs slowed to 25.3% growth in April from an average of over 60% during 1993. Growth in industrial production has slowed to 17.9%, and the overt inflation has slowed down (as discussed above). The strongest evidence for a real slowdown is from one of the few real activity indicators, the overall volume of domestic freight traffic, the year-on-year growth rates of which has been in negative territory since mid-1994. The official real GDP growth rate has slowed from 13.8% in 1993 to 11.2% in the first quarter of 1995, with most of the

CHINA: CHART 8
INVESTMENT, SALES AND PRODUCTION



GDP growth accounted for by net exports and (presumably involuntary) inventory accumulation. However, the GDP deflator is of a much smaller magnitude than other inflation indicators, and the improvements in the measurement of GDP (i.e. a gradual narrowing of previous gross underestimation of the level of GDP) probably means that the growth rate of the official real GDP figures overstate the actual real economic growth rate in China. The poor quality of data therefore makes it difficult to assess the magnitude of China's current economic slowdown, although most of the data supports the view that a slowdown is in progress.

However, this slowdown has so far not been sufficient to cure China's inflation problem. The last time China overcame inflation it took a severe slowdown from 1989 to 1990, with attendant social unrest. The authorities will probably want to avoid a repeat of that situation, and will probably be satisfied if they can reduce the official inflation figures to 10%-15%. Also, the period of political succession ahead will necessitate a gathering of support behind the new leadership, which it will be tempting to secure with an easing of economic policy (even if only a selective or modest one). There is also a risk that essential but politically difficult economic reform measures (e.g. reform of SOEs, state banks, legal system and social security) may be delayed.

SUMMARY AND CONCLUSIONS: China has made great strides in modernising its economy, reducing the role of the plan and increasing the role of the market, and successfully attracting large amounts of capital inflows. Recently the authorities have managed to implement a tightening of credit policy to cool down the overheating economy and reduce inflation. However, both the tightening and the slowdown has been uneven across sectors, adding to distortions and allocative inefficiencies.

During the period of political succession ahead, there is a significant risk that the authorities will loosen credit policy prematurely, reverting to a path of high growth, high inflation and inevitably intermittent devaluations (a la Korea in 1960s and 1970s). Although such an easing of credit conditions may provide a boost for the prices of equities available to domestic investors, the resulting dent in economic policy credibility may well offset any gains in the shares available to foreign investors.

INDIA TESTING TIMES AHEAD FOR STATE FUNDING

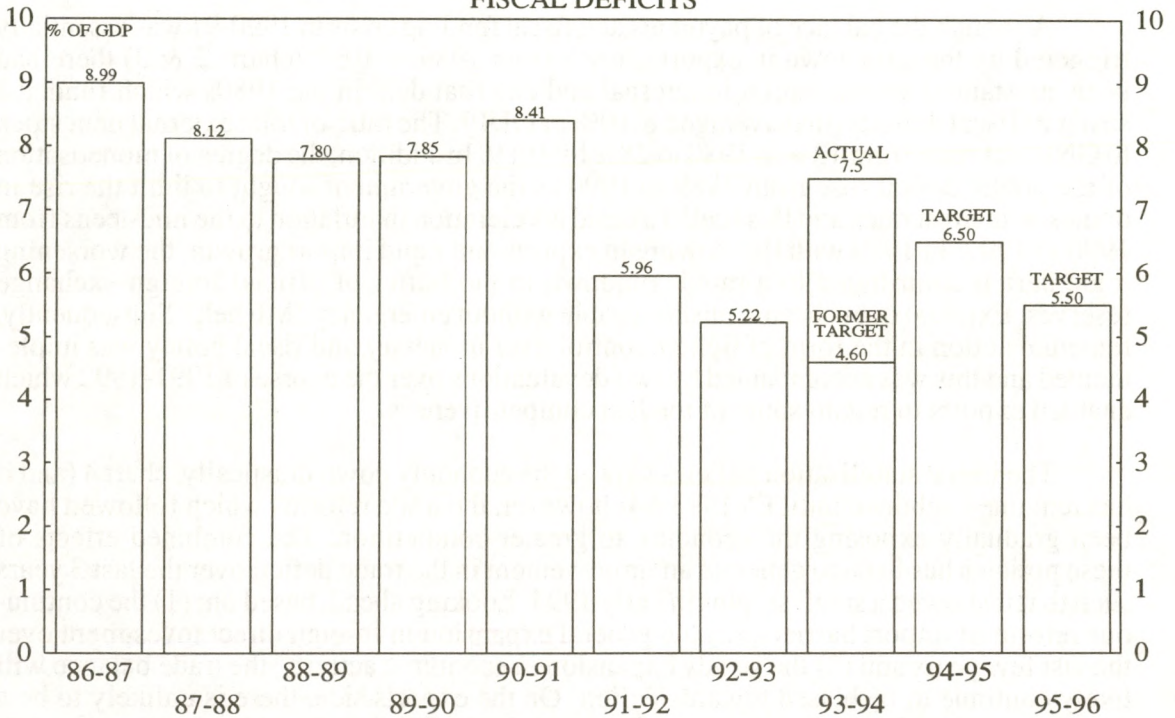
Introduction

Much has been written about the deregulation in the areas of trade and foreign investment in India in recent years. These remain key areas of reform because they are necessary to bring about the capital accumulation, competitiveness gains and ultimately higher income growth that policymakers seek. However, equally important is the need to cut back the size of the state sector. Using the measure of total government expenditure to GDP, the decline in this ratio since 1990-91 has been minimal (in FY1990-91 this was 19.8 %, while in FY1993-94 this stood at 17.8 %). Meanwhile the fiscal budget deficit which, relative to GDP, had been successfully reduced in the years following the fiscal funding and balance of payments crises in 1990-91, has recently shown worrying signs of expansion (in FY1993-94 this came to 7.3% of GDP compared with 5.2% in the previous year: chart 1).

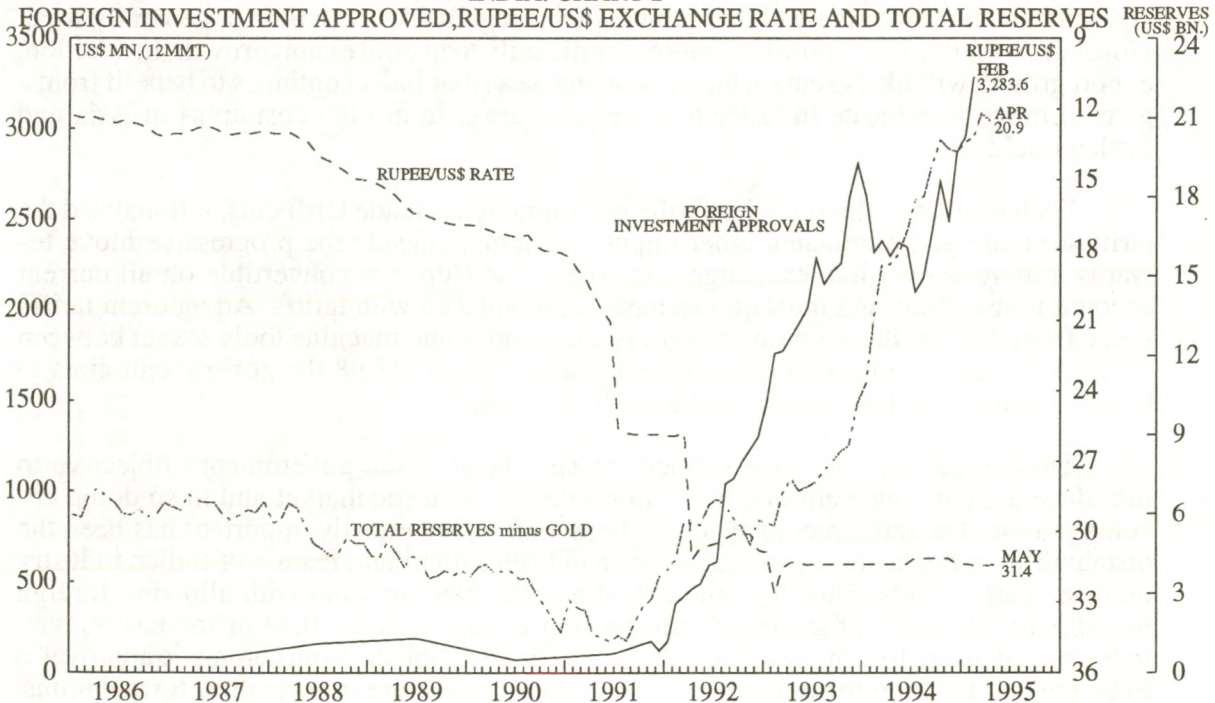
After a brief assessment of the pattern of the reforms in trade and industry introduced since 1990-91 -- the most widely trumpeted aspect of government policy -- this article moves on to examine the government finances more closely especially in the context of monetary policy. Although there appears to be no immediate threat to macroeconomic stability from last year's fiscal deficit, the cost of funding it is already rising and this trend will likely continue over the next couple of years. There has been a progressive move towards market orientated public sector funding and away from the tendency to monetise the fiscal deficit through the issue of ad-hoc 91 day T-bills. Given this, the government will find it harder to contain a given fiscal deficit in the immediate years ahead, not least because it will mean trimming the primary budget deficit (net of non tax income and interest repayments). This expanded in 1993-94 and is unlikely to be brought under control in 1995-96, the year leading up to and including the general election. In a benign monetary environment, this would involve a greater degree of crowding out of private sector lending from commercial banks balance sheets and a rising interest rate burden (causing the public debt to GDP ratio to rise). Interest rates on private sector lending activities may be bid upwards by the higher rate offered on government securities. As a result at some stage there would be an increased risk of a rise in the monetisation of the fiscal deficit.

Under the present monetary conditions the risk of increased monetisation of the fiscal deficit in 1995-96 and therefore of higher inflation is greater. Today in the aftermath of a tremendous bull market in securities prices and monetary expansion, the ongoing rises in interest rates (consistent with tighter monetary policy) are placing an extra load on public sector deficit funding. That is, the overall accumulation of government debt will be growing more rapidly as a result of both a rise in the primary deficit and from higher interest rates on the shorter term and newly issued longer term debt. Consequently, over the next 12 months while credit conditions may appear to be squeezed (in the sense that private sector working and investment related capital demands will abate in response to higher rates) there is an increasing risk that the RBI will be forced to accommodate more of the public sector deficit. This would represent a reversal in monetary policy, which has been tightened since October 1994. This monetary policy change would be motivated by the desire to reduce the degree of crowding out and in particular to limit the rise in interest rates -- in an election year -- which may partly relate to an expanding supply of government paper, but which has led to a higher cost of funds for the government.

INDIA: CHART 1
FISCAL DEFICITS



INDIA: CHART 2
FOREIGN INVESTMENT APPROVED, RUPEE/US\$ EXCHANGE RATE AND TOTAL RESERVES



Trade Performance and Reforms

Although the balance of payments and fiscal funding crisis in 1990-91 was essentially triggered by the slowdown in export growth from 1989 to 1991 (charts 2 & 3) there had been substantial accumulation in internal and external debt in the 1980s which funded a string of fiscal deficits (that averaged 8-10% of GDP). The ratio of total external debt stock to GNP had risen from 12% in 1980 to 28% by 1989. In addition, the degree of monetisation of the public deficit rose from 1989 to 1990 as the government sought to limit the rise in domestic interest rates and this fueled a rapid acceleration in inflation to the mid-teens from 1990 to 1992. In 1989 with the slowing in exports and rapid import growth, the worsening trade deficit contributed to a rapid rundown in the buffer of official foreign exchange reserves. External debt became unserviceable without emergency IMF help. Subsequently, remedial action in the form of tighter control over monetary and fiscal policy was implemented and this was accompanied by two devaluations over the course of 1991-1992 which enabled exports to regain some of the lost competitiveness.

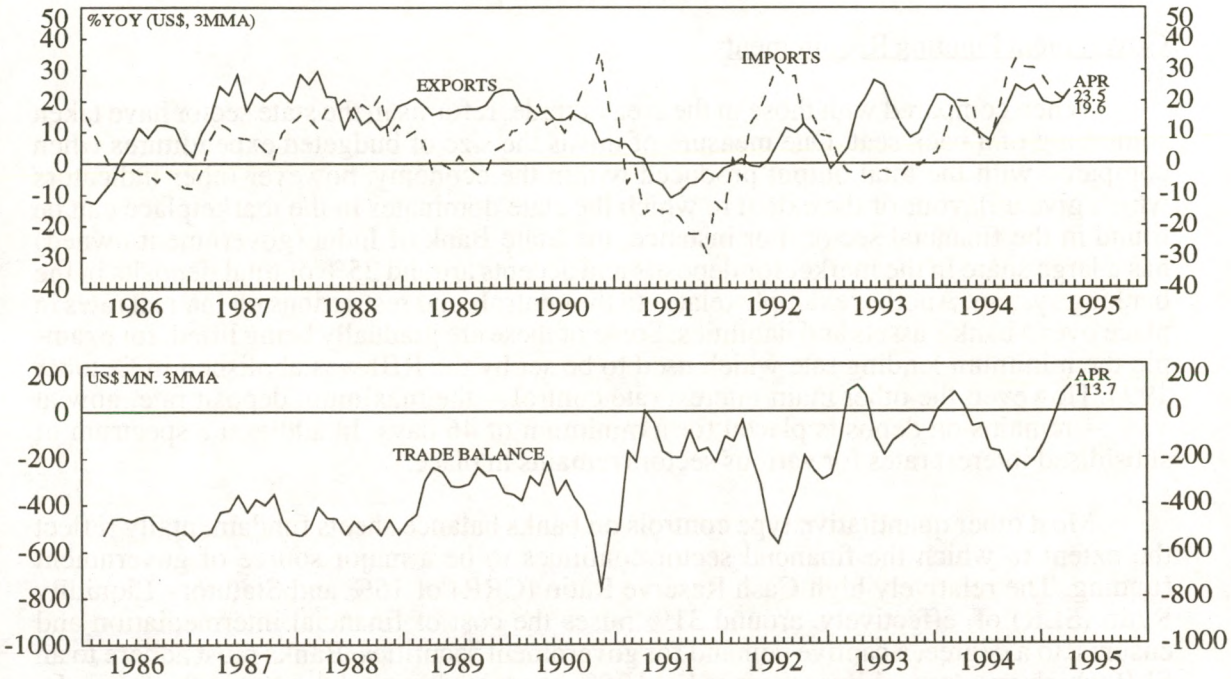
The initial stabilisation policies slowed the economy down drastically, chart 4 (and it has remained subdued until FY1993-94) however, the trade reforms which followed have been gradually exposing the economy to greater competition. The combined effects of these policies has been to generate an improvement in the trade deficit over the last 3 years such that it showed a small surplus in early 1994. Looking ahead, based on: (1) the continuous reform of import barriers, (2) the general expansion in foreign direct investment over the last few years and (3) the steady expansion in economic activity, the trade balance will likely continue to be biased towards deficit. On the exports side, there is unlikely to be a significant general upswing if economic growth in the US, Japan and Europe continues to slow or remains subdued, since these destinations account for approximately 22%, 8% and 30% of India's total exports respectively. However, Asia (excluding Japan) absorbs around 20% and given the relatively higher growth in this region (even at a time of generally weak global growth) this may contribute more significantly to overall export growth. In addition, export growth will likely remain buoyant on the basis that India continues to benefit from a general move to relocate industry to lower cost areas from high cost areas in Asia and further afield.

Each year since the early 1990s the government has made tariff cuts, rationalised the tariff structure and eliminated other import barriers alongside the progressive move towards a more convertible exchange rate. Today the Rupee is convertible on all current account transactions and most quotas have been replaced with tariffs. Ad valorem tariffs range from 0-65% (those on raw materials, electronics and machine tools are set between 25%-65%) with various concessions for exporters. By 1997-98 the government aims to have brought down these tariffs to the 15-30% range.

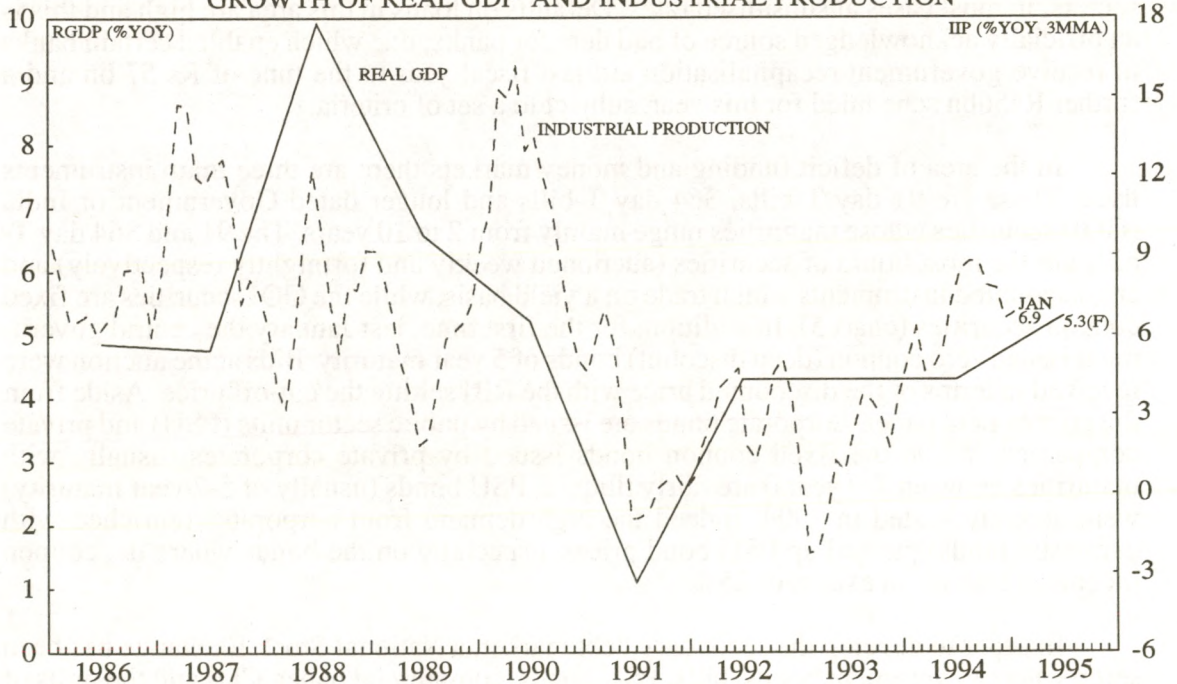
These trade reforms have formed the spearhead of the government's objective to introduce a greater element of competition into the domestic market and in so doing encourage more foreign direct investment. Less visible, but equally important has been the dismantling of the licensing system which had been a dominant feature of Indian industry until the early 1990s. This, to some extent has run hand in hand with allowing foreign investment into areas of domestic industry. For example, at the time of the last budget, industrial licensing for almost all bulk drugs was finally abolished and automatic approval is to be granted for foreign equity up to 51% in the manufacture of most drug formulations. In some areas within the exporting sector, corporate tax holidays reflect a substantial incentive to redirect resources towards satisfying overseas demand. This contrasts with the controls and restrictions present a few years ago, which caused production to be biased

May-June 1995

INDIA: CHART 3
TRADE PERFORMANCE



INDIA: CHART 4
GROWTH OF REAL GDP AND INDUSTRIAL PRODUCTION



towards serving the home market. These changes are gradually transforming the economy to a more market orientated one and will help to raise its long run potential output.

Government Funding Requirements

When compared with those in the area of trade, reforms in the state sector have taken something of a back seat. One measure of this is the size of budgeted expenditures when compared with the total output produced within the economy, however other indicators which give a flavour of the extent to which the state dominates in the marketplace can be found in the financial sector. For instance, the State Bank of India (government owned) has a large share in the market for deposits and accepts around 25% of total deposits in the banking system. Another example relates to the controls and restrictions on interest rates in place over a bank's assets and liabilities. Some of these are gradually being lifted, for example the minimum lending rate which used to be set by the RBI was abolished in October 1994. However, the other main interest rate control -- the maximum deposit rate, now at 12% -- remains on deposits placed for a minimum of 46 days. In addition a spectrum of subsidised interest rates for various sectors remains in place.

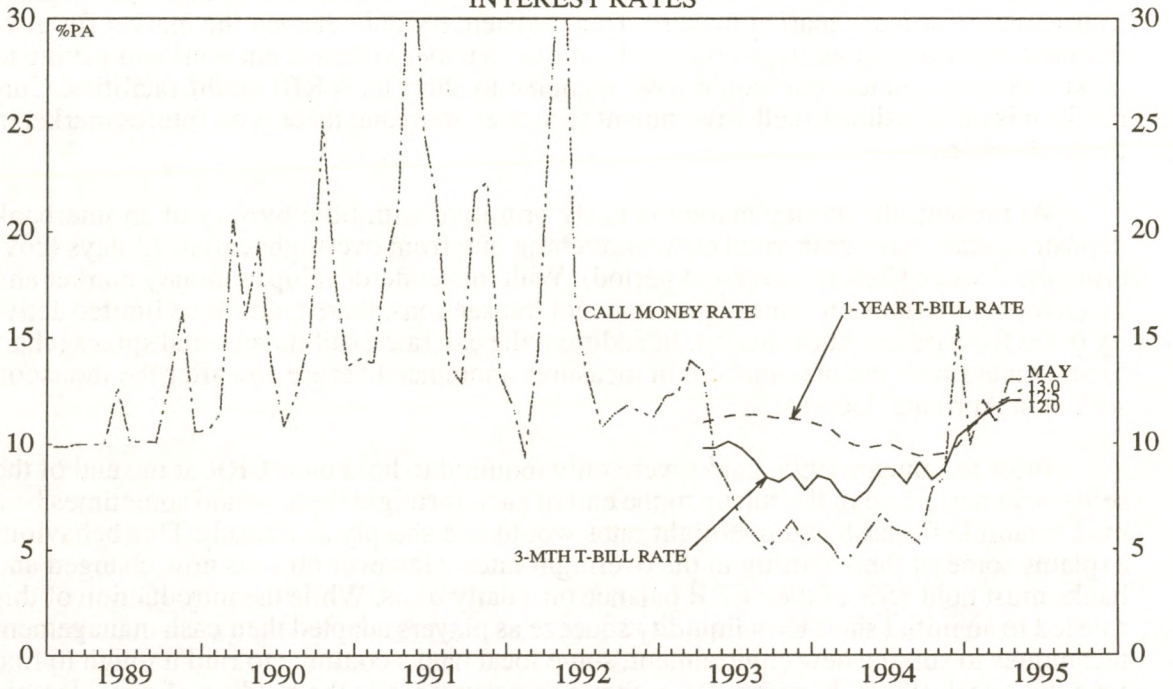
Most other quantitative type controls on banks balance sheets fundamentally reflect the extent to which the financial sector continues to be a major source of government funding. The relatively high Cash Reserve Ratio (CRR) of 15% and Statutory Liquidity Ratio (SLR) of, effectively, around 31% raises the cost of financial intermediation and ensures, to a degree, a captive demand for government securities. Banks must adhere to an SLR which currently obliges them to hold 25% of each additional deposit in the form of a liquid asset (which usually means a government security). This then, enables the government to fund the fiscal deficit relatively cheaply, especially during a time of rising inflationary expectations. The higher intermediation costs (and therefore higher spreads) are further aggravated by the restriction that obliges banks to lend 40% of credit to "priority" sectors, in most cases at subsidised rates. Defaults on loans in this area are high and this is an officially acknowledged source of bad debt for banks; one which enabled certain banks to receive government recapitalisation aid last fiscal year to the tune of Rs 57 bn and a further Rs56bn scheduled for this year, subject to a set of criteria.

In the area of deficit funding and money markets there are three main instruments used. These are 91 day T-bills, 364 day T-bills and longer dated Government of India (GOI) securities whose maturities range mainly from 2 to 10 years. The 91 and 364 day T-bills are the most liquid of securities (auctioned weekly and fortnightly respectively) and are discounted instruments which trade on a yield basis, while the GOI securities are fixed coupon securities (chart 5). In addition, for the first time, last January the central government issued zero coupon (deep discount) bonds of 5 year maturity. Bids at the auction were received in terms of the discounted price with the RBI setting the cut-off price. Aside from the government paper, corporate bonds are issued by public sector units (PSU) and private companies. While the fixed coupon bonds issued by private corporates (usually with maturities between 7-9 years) are fairly illiquid, PSU bonds (usually of 5-7 year maturity) were actively traded in 1994. Indeed the high demand from corporates (enriched with euroissue funds) pushed up PSU bond prices, especially on the bonds where the coupon income is taxfree, in excess of 25%.

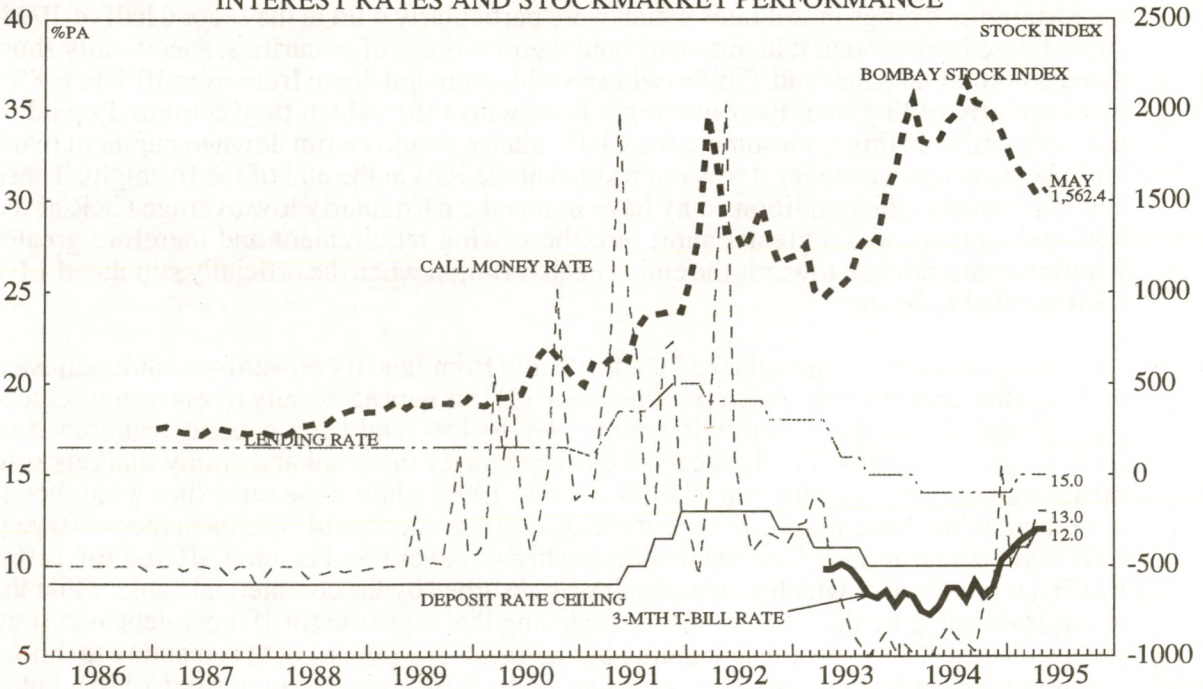
In order to develop the secondary debt market, a National Stock Exchange has been setup where government bonds, bills, PSU bonds, commercial paper, CDs and the units of the '64 scheme of the UTI are traded. However volumes have been low, reaching Rs24.4bn in January this year. The computerisation of the Subsidiary General Ledger (SGL) ac-

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INDIA: CHART 5
INTEREST RATES



INDIA: CHART 6
INTEREST RATES AND STOCKMARKET PERFORMANCE



counts which banks, financial institutions and corporates need to hold at the RBIs public debt offices has facilitated secondary market trading. The RBI is also trying to put in place a structure of primary market makers. Their existence would deepen the market for government securities by having certain obligations as underwriters at auctions and having to make two way quotes, but would have recourse to short term RBI credit facilities. Currently, it is not possible to sell government securities short and there is no futures market in these securities.

At present, the money market is fairly primitive with little by way of an interbank deposit market, but a cash yield curve stretching out from overnight call to 13 days (covering the 2 week CRR requirement period). With this underdeveloped money market and given the restrictions on some capital account transactions, there tends to be limited activity in the forward currency market. In addition, the call rate exhibits seasonal spikes (chart 5) associated with the biannual credit measures announced before and after the monsoon season in April and October.

Prior to January 1995, banks were only required to hold their CRR at the end of the settlement period, so in the run up to the end of each fortnight there would sometimes be a mad scramble for cash and overnight rates would rise sharply as a result. This behaviour explains some of the volatility in the overnight rates. However this has now changed and banks must hold 85% of their CRR balance on a daily basis. While the introduction of this rule led to an initial short term liquidity squeeze as players adapted their cash management techniques to suit the new environment, some local banks continue to find it tough to fine tune their cash flows. In particular, a common occurrence is the holding of considerable precautionary excess cash for the first few days of the period before lending it out vigorously at the last minute, possibly bidding down bill yields.

This change to daily monitoring of reserve requirements was designed to attenuate the fortnightly swings in call rates which were particularly wild in the second half of 1994. At that time banks found it lucrative to fund their holdings of securities, specifically short dated commercial paper and T-bills (whose yields were bid down from over 10% to 6-8%) by constantly rolling over their overnight borrowings (for which they commonly paid 5-6%). Naturally, in this environment the CRR balance would be run down to augment overnight borrowings whenever it was not needed at the RBI at the end of the fortnight. These generally easy credit conditions may have induced a particularly low average CRR at the RBI and so there was a greater short term borrowing requirement and therefore greater gyrations in the call rate towards the end of each fortnight when the officially stipulated 14% CRR needed to be met.

Liquidity conditions tightened up drastically from January onwards as banks adjusted to the higher cost of funds which resulted from: (1) this new 85% daily reserve requirement rule, (2) the rise in the overall CRR from 14% to 15% and (3) a general withdrawal of foreign funds and repatriated proceeds. Unsurprisingly the bond and equity markets sold off substantially towards the end of 1994 and into 1995, while at the same time a number of government bond auctions have been increasingly less successful. The most recent 10 year GOI bond tender in mid-June resulted in the highest ever fixed coupon offered (of 14%). Rs17bn was raised, of which just over half was absorbed by the commercial banks while the rest was taken up by the RBI. Investors are losing their appetite for 10 year debt at current yields (close to 14%) and are demanding higher rates. The government is reacting to this by continuing to fund at present rates, i.e. at around 13-14% yield to maturity (YTM), but at a shorter part of the 'curve.' Table 1 below shows that over a period of years there has been a significant rise in the stock of government loans outstanding of maturity between 5-10

years, since 1990.

Table 1: Maturity-wise distribution of GOI Rupee borrowings (% of total)

	Over 10 years	5-10 years	Under 5 years
FY1990	83.0	6.0	11.0
FY1991	85.8	5.6	8.6
FY1992	75.8	16.8	7.4
FY1993	77.8	14.2	8.1
FY1994	57.4	27.7	14.9

The Fiscal Deficit

As can be seen from the table below, interest payments are a large and growing proportion of total expenditure. Where in FY1989-90 total interest rate repayments accounted for around 19% of total government spending, by FY1994-95 this had grown to 27%. The next largest specific expense item for the government is defense. It has remained fairly stable as a percentage of total expenditures and annually eats up around 15%. This leaves the rest of the expenditures, most of which take the form of: subsidies, grants and loans to the States, and to a vast multitude of industries.

Table 2: Measures of the Public Sector Deficit

	89-90	90-91	91-92	92-93	93-94	94-95 RE	95-96 BE
Revenue Deficit (Rs bn)	119	185	163	186	327	537	522
(as % GDP)	2.6%	3.5%	2.6%	2.6%	4.1%	5.6%	5.0%
Fiscal Deficit (Rs bn)	356	446	363	401	602	610	576
(as % GDP)	7.8%	8.4%	5.9%	5.7%	7.6%	6.5%	5.5%
Budgetary Deficit (Rs Bn)	106	114	69	123	109	60	50
(as % GDP)	2.3%	2.1%	1.1%	1.7%	1.4%	0.6%	0.5%
Primary Deficit (Rs bn)	180	231	97	90	236	170	56
(as % GDP)	4.0%	4.3%	1.6%	1.3%	3.0%	1.8%	0.5%
Interest payments as % Total expenditure	19%	20%	23.8%	25.3%	25.8%	27%	30%
Annual internal market borrowings as % of total expenditure ¹	27%	24.7%	19.8%	14.7%	30.6%	28.2%	23.9%

¹ Excludes privatisation proceeds, net external debt, and recovery of loans but includes small savings, net state provident funds and net special deposits.

Privatisation proceeds begin to enter from 1991-92 onwards in Fiscal & Budget deficit figures.

Re = Official revised estimates, BE = Official budget estimates

Table 2 above shows a number of different measures of the public sector deficit. The revenue deficit takes the difference between the tax plus non-tax revenue and current expenditures (including interest repayments) and gives an indication of net government consumption. The fiscal deficit includes capital expenditures and capital proceeds from privatisations and loan recoveries. This is therefore one of the broadest public sector deficit measures. A broader one still, the budget deficit, adds in those receipts from all new market borrowings net of amortisations. This gives an indication of that part of the public debt (expenditures) which is held (financed) by the RBI. It is also important to examine a measure of the primary deficit, that is one that excludes all interest repayments, new market borrowings and capital proceeds. This is the source of all future borrowings and (in the absence of unanticipated monetisation) it is only by cutting this and ultimately running a surplus here that the government can reduce its overall debt burden and make its financing less vulnerable to higher interest rates and falls in income growth.

In the table above, all deficit measures showed an improvement from 1991 to 1993, however in the last fiscal year there was a substantial deterioration in the primary and fiscal deficits. The fiscal deficit was officially expected to weigh in at around 4.2% of GDP, instead of the actual of around 7.6%. However, the easy liquidity conditions at that time enabled the government to fund this with relative ease and so net market borrowings as a proportion of total expenditures rose. As a result the budget deficit remained fairly stable. In addition, under these conditions the dangers of RBI monetisation of government debt were minimal, so the anti-inflationary rule (introduced in March 1994 which places a ceiling on the ad-hoc 91-day T-bills held by RBI) proved an easy one to abide by and is frequently quoted as living proof that the government has escaped the stop-go policies of the past.

Looking ahead, in the ongoing high interest rate environment in 1994-95, it will prove more difficult to fund the fiscal deficit without the interest rate burden on the debt escalating to a much greater degree. This increases the possibility of a rise in the overall monetisation of the public sector deficit. The ability of the government to contract its primary deficit during this time of higher interest rates is crucial to the stability of the debt to income ratio and this is going to be sorely tested at least in the next year (and fundamentally for as long as the government delays making drastic cuts in the overall size of the state sector).

One of the major, potential sources of change in the fiscal deficit, is the government's ability to continue to service its debt before it is forced to reduce its primary deficit. The introduction of the ceiling for RBI monetisation of ad-hoc T-bills (set at Rs 60bn in FY1994-95) has closed one of the potential avenues of RBI funding which was available to the government. In the absence of the RBI accumulating other instruments which finance government spending, the government is left with two main sources of funding. It can borrow domestically by issuing paper to be taken up either by the banking sector, the Small Savings and Provident Funds, or from abroad (in foreign currencies). With respect to internal debt, the ability of the government to service this essentially depends on the interaction between three variables: GDP growth, the interest rate (government bond yield) and the primary government deficit (the fiscal deficit net of non-tax income and interest payments). (See box on p. 33.) The final section of this article gives a resume of recent monetary policy and prospects for future developments.

DEBT DYNAMICS.

If we let the internal stock of government debt be denoted by D , GDP growth by g , the level of GDP by Y , the interest rate by r , and the primary government budget deficit by B , then the following equation describes the condition that must be met for stability between public debt and income.

$$A(g - r) = B / Y$$

where A is the ratio of debt to income. This equation makes it clear that in simple terms if the interest rate exceeds the growth of GDP, then the government would have to run a primary budget surplus if the (marketable) debt to income ratio is to remain stable. In addition, the larger the debt to income ratio (A), the larger the adjustment in the primary surplus that the government would have to make if interest rates moved adversely. Of course throughout the year the government would be borrowing at a range of interest rates and some of the rise in the primary deficit could be dealt with using moral suasion on some institutions and by running down various deposits. In addition the government has the option of raising the level of external debt.

In an environment where interest rates are rising more rapidly than GDP growth (as may happen over the next 1-2 years in India) one would expect to see two trends. First, given the political difficulty of reducing a primary deficit in the immediate year ahead, the debt to income ratio would probably rise (i.e. more debt would have to be issued as the cost of servicing a given primary deficit rises). This may give rise to greater monetisation. Second, after the debt had been allowed to escalate, the government would at some stage attempt to rein it in, which implies cutting back on the primary deficit. Speeding up privatisation (divestment process) of state assets would be one way of doing this. Table 3 gives an (annual) indication of the past movements in these variables.

Table 3: Income, Debt and the interest rate

Variable.	1992-93	1993-94	1994-95	1995-96
B (bn)	90	90	236	170
Y (bn)	7055.7	7965.9	9455.5 RE	10478.9 BE
D (market borrowings bn)	3359	4007.3 RE	4574.4 BE	--
A (=D/Y)	47.6%	50.3%	48.3%	--
g	14.6%	13%	18.7%	10.8%
r	10.3-13.2%	8.7-13.5%	11.5-13.3%	--

note: -stock of market borrowings includes that held by small savings and provident funds.

-r is a range of maximum and minimum redemption yields on GOI securities of maturity from under 5 years to over 10.

-Re = Official revised estimates, BE = Official budget estimates

Monetary Policy

During FY1993-94 around US\$ 4bn was invested in India against euroissues of Indian companies, investment by foreign institutional investors (FIIs) and direct foreign investment in Indian companies. Consequently investment in equities and government securities exploded and drove down yields (chart 5 & 6). With the maximum deposit rate (still officially set) at 10% funds found more lucrative returns outside the banking sector in the intercorporate deposit market, while at the same time, corporates could borrow by issuing commercial paper at rates similar to those on T-bills (i.e. less than the (previously) stipulated 14% minimum lending rate). Three month T-bills fell from 13-14% to around 7-9% with the overnight call averaging 5-6%. However, from October onwards these easy monetary conditions which were fueling more speculative gains reversed as conditions in the financial markets tightened up for a variety of reasons.

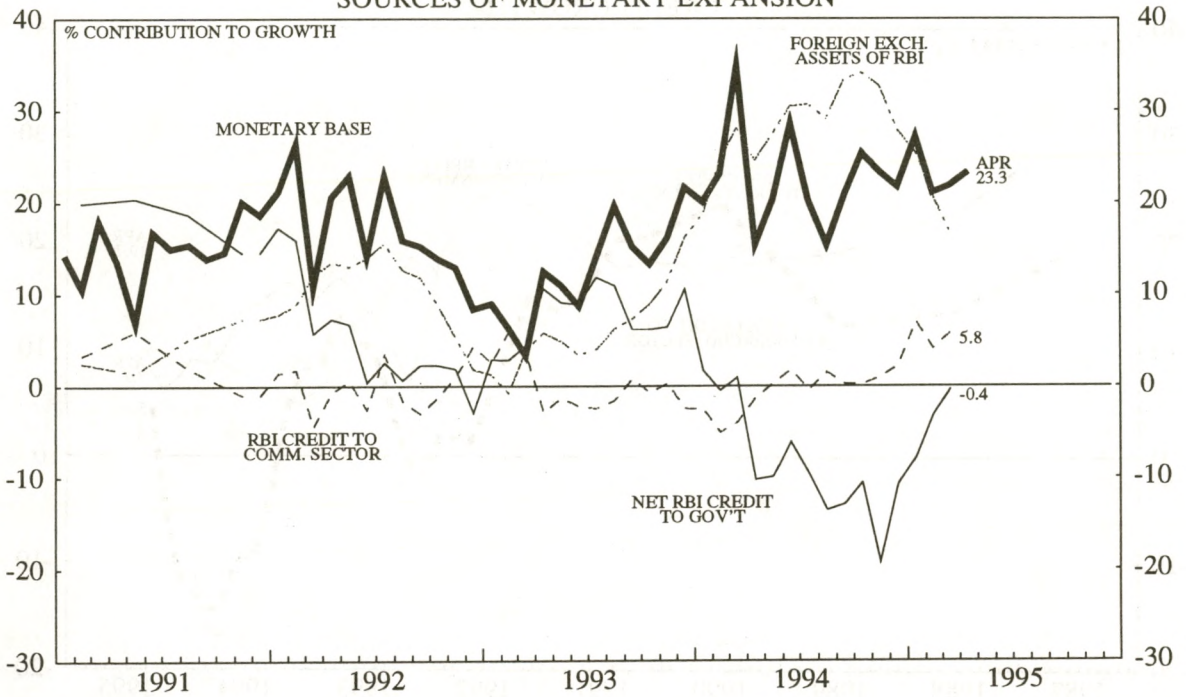
Firstly, the Cash Reserve Ratio (CRR) was hiked in stages from 14% to 15%. In addition banks were required to maintain 85% of this deposit with the RBI on a daily basis (as well as the previous fortnightly average) as explained previously. For foreign banks their cost of funds rose as the RBI imposed a 15% CRR on foreign currency non-resident deposits (where there used to be none). Secondly, the number of euroissues has subsided since the end of last year. The last relatively large one being the \$140m issue by Ashok Leyland in February. In addition and in an attempt to lessen the upward pressure on the Rupee last year, the RBI permitted companies to bring in their euroissue proceeds only at the time the funds were required by the company. This rule came into effect at the beginning of this year.

Notwithstanding these latest moves in rates, the expansion in the monetary base during 1993 and 1994 has led to a strong upswing in broader monetary growth (charts 7 and 8). This expansion has the unique feature that its origins lay in the accumulation of foreign assets and more specifically from a foreign investment boom rather than one driven by exports. This higher monetary growth has helped the banks to recover some of the bad debt losses that had been lingering from the recession in the early 1990s and enabled them to grant credit to the private sector more aggressively (chart 9). Bank credit to the private sector which accounts for around 54% of M3, has accelerated since mid-1994 to 17% year-on-year growth, while lending to the government has decelerated.

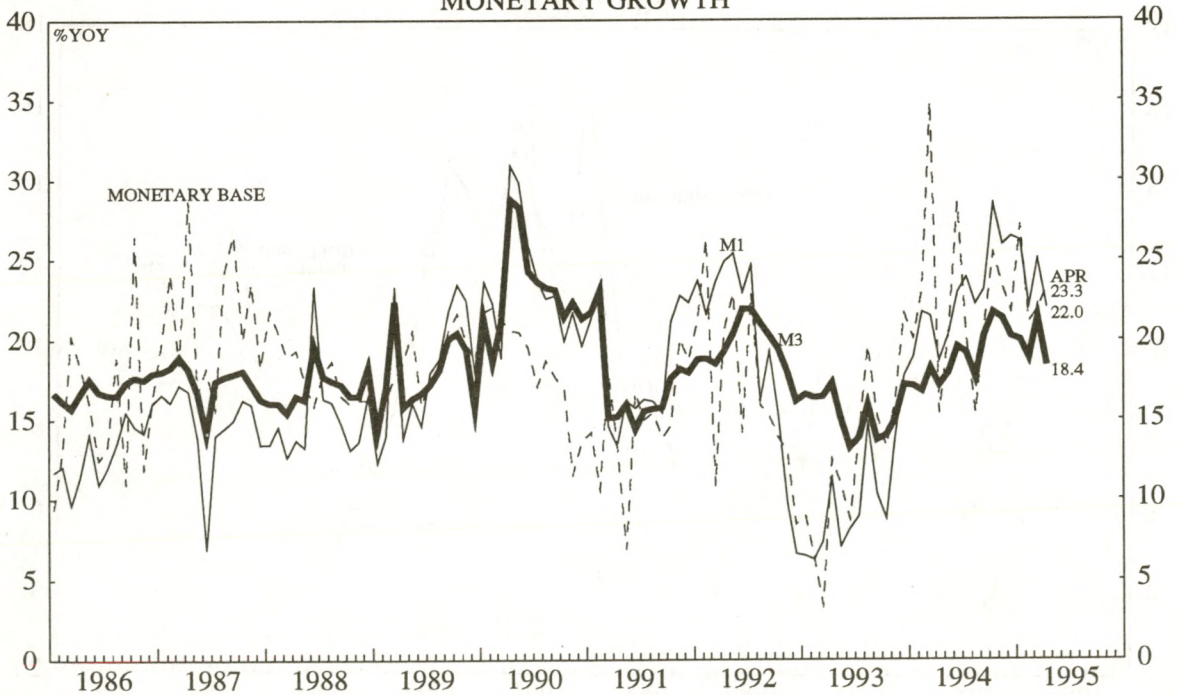
As in previous monetary upswings, the trend in CPI growth has followed suit after a lag of 6-12 months. On this occasion the CPI rate had reached double digits by Autumn (see Chart 10). Given the accelerating inflation together with the prospect of a general election sometime in 1996, the RBI took the opportunity to tighten credit conditions last October. As (near) double digit inflation looks likely to persist, the RBI may continue to implement various quantitative restrictions and would aim to see further interest rate hikes in an effort to limit credit to the private sector this year. In the recently released credit policy this April, the RBI restated its anti-inflationary objective and raised deposit rates by 1% to 12% while it has restricted credit to some firms and finance companies and banned bridge loans to firms awaiting share issue proceeds. Some major banks have already raised their prime rates by 1% to 16%.

Further restrictions would ration credit to the private sector further and push up interest rates. However, a continuation of a large public sector borrowing requirement this year would, against the prospective monetary background, result in more intense competi-

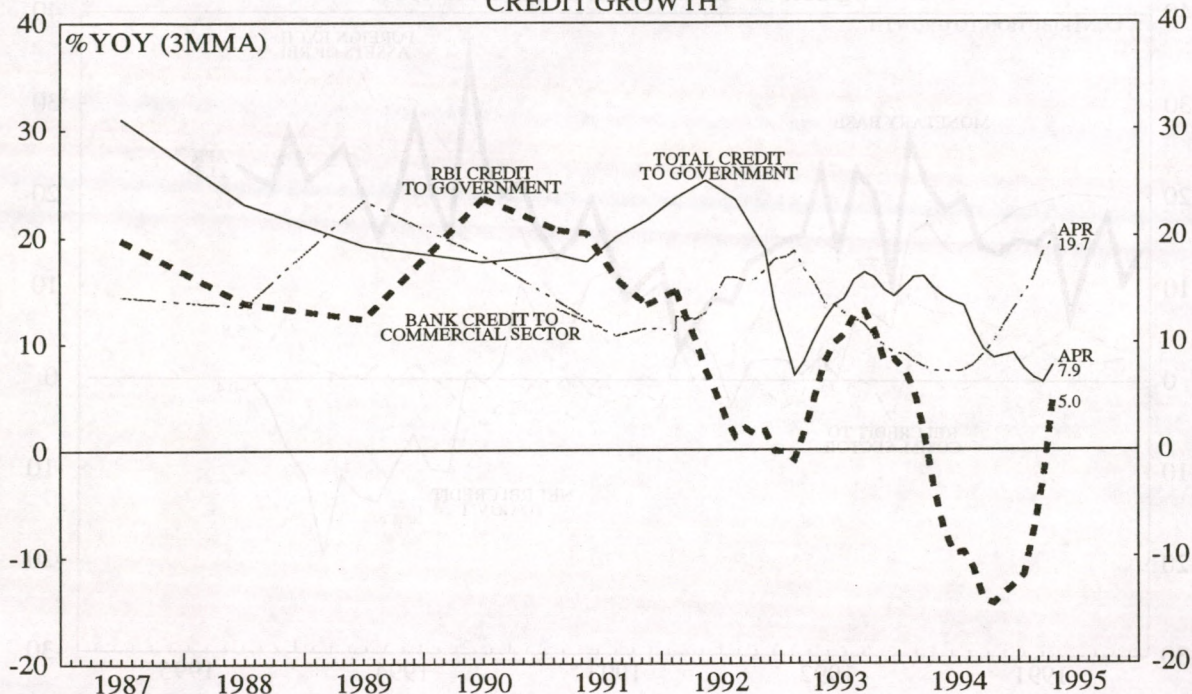
INDIA: CHART 7
SOURCES OF MONETARY EXPANSION



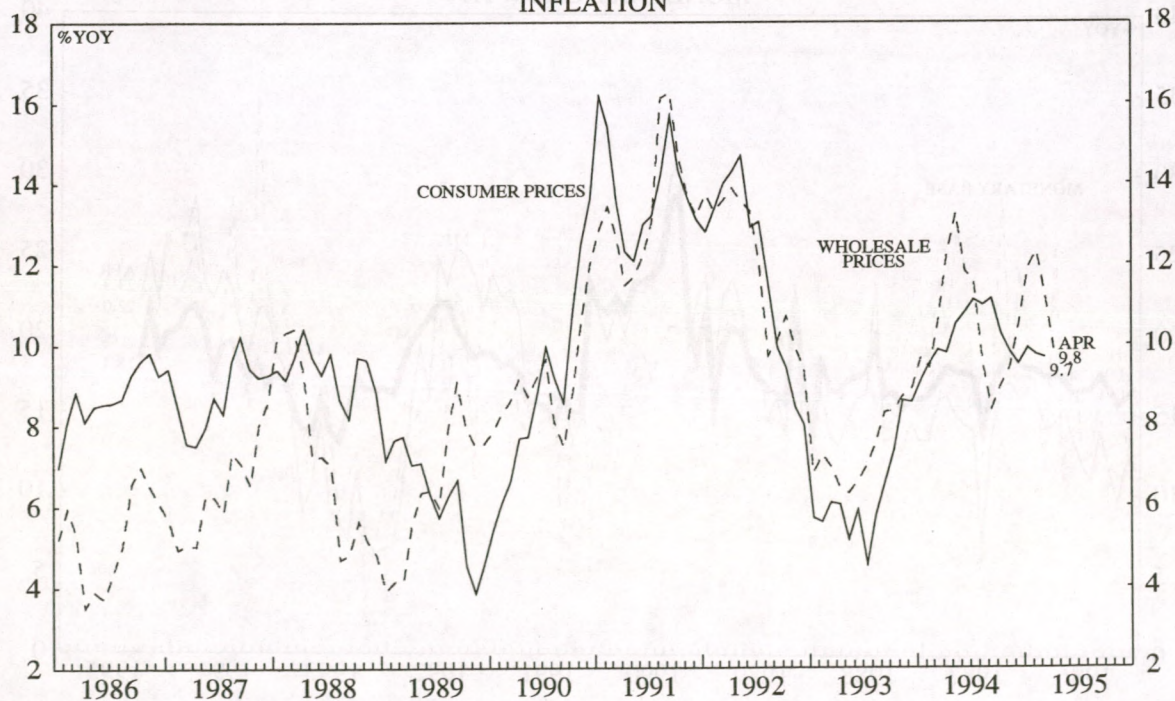
INDIA: CHART 8
MONETARY GROWTH



INDIA: CHART 9
CREDIT GROWTH



INDIA: CHART 10
INFLATION



tion for credit and the structure of lending rates along with yields on securities would rise. Given that the general election will be held sometime in early 1996 (it must be before June), increasing pressure could be placed on the RBI to accommodate some of the potential increase in government spending. If the RBI were to monetise a greater element of the public sector deficit, this would contribute to a further expansion in the monetary base and may place a "cap" on the yields on government securities. With little adverse change in the balance of payments, this would augur for a continuation in the strong growth in M3 and for persistently high inflation in 1996. Chart 7 shows that although the contribution to monetary base growth from the foreign component has declined, the overall growth in monetary base remains strong. In addition, despite the recent credit tightening measures and higher interest rates, the monetary aggregates are still growing rapidly so the present economic upturn looks set to remain in place for the next year while CPI inflation will likely continue to grow strongly at close to double digit levels (and therefore remain a policy concern for at least the rest of this year).

At present the trade position is close to balance, however, as mentioned in the first section this is likely to deteriorate in the year ahead partly as a result of strong import demand. In addition, there has recently been a slowing in the influx of foreign capital although this has not resulted in persistent downward pressure on the Rs/US\$. While the foreign component of the monetary base (in Chart 7) has slowed this has not been of sufficient magnitude to directly bring about tighter monetary conditions. In the year ahead as more investors build in longer term expectations of stable or declining interest rates in the US, the appetite for Indian (and other emerging market) assets will expand and it may be possible for the trade account deterioration to be offset by a greater influx of foreign capital such that balance of payments pressures present a mildly positive or even neutral impact on monetary conditions in the year ahead.

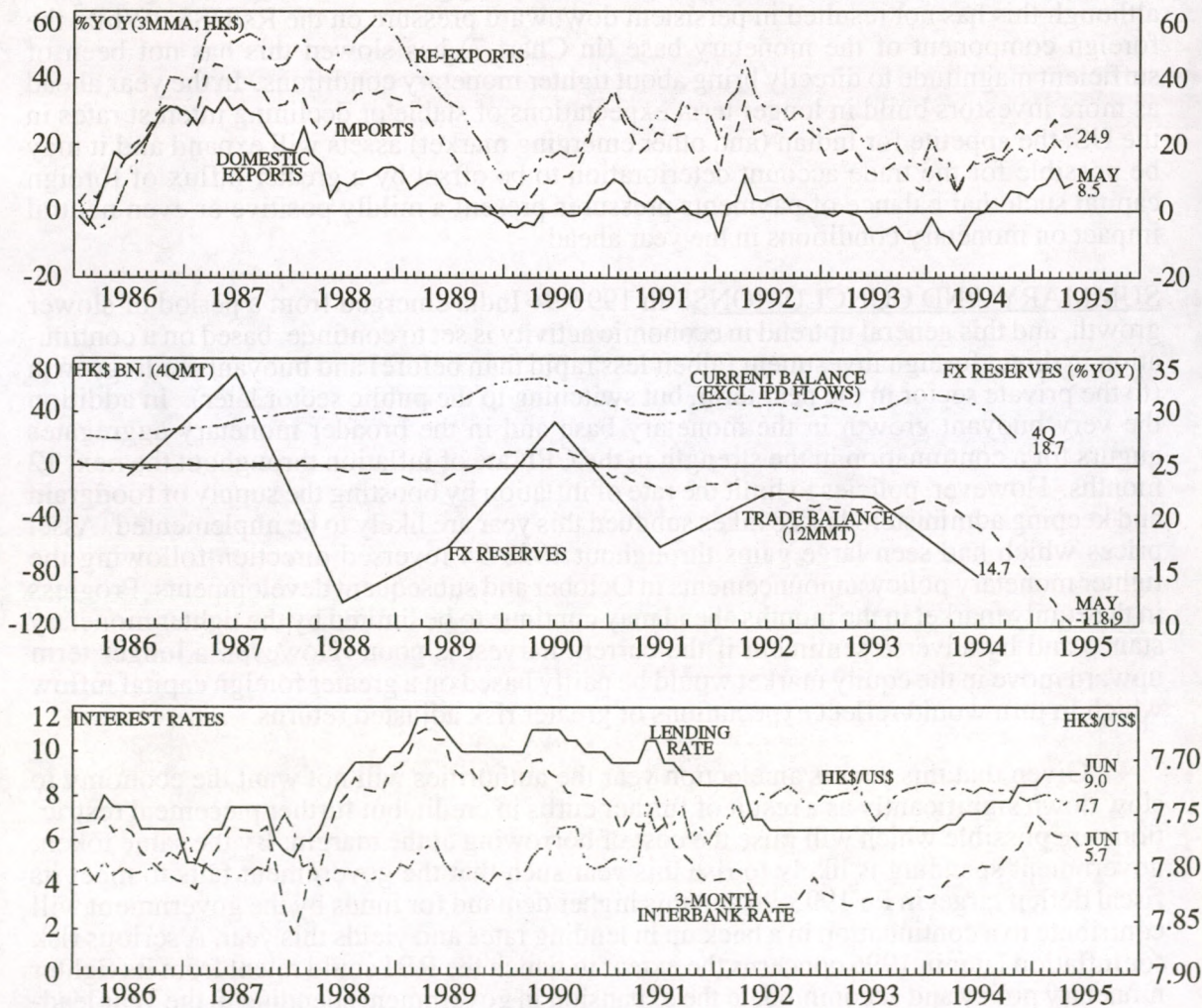
SUMMARY AND CONCLUSIONS: In 1993-94 India emerged from a period of slower growth, and this general uptrend in economic activity is set to continue, based on a continuation in direct foreign investment (albeit less rapid than before) and buoyant credit growth (to the private sector in the near term, but switching to the public sector later). In addition the very buoyant growth in the monetary base and in the broader monetary aggregates augurs for a continuation in the strength in the CPI rate of inflation throughout the next 12 months. However, policies to limit the rate of inflation by boosting the supply of foodgrain and keeping administered price hikes subdued this year are likely to be implemented. Asset prices which had seen large gains throughout 1993-94 reversed direction following the tighter monetary policy announcements in October and subsequent developments. Progress in the equity market in the months ahead may continue to be limited by the tighter monetary stance and by adverse sentiment if the current harvest is poor. However, a longer term upward move in the equity market would be partly based on a greater foreign capital inflow which in turn would reflect expectations of greater risk adjusted returns.

Given that this year is an election year the authorities will not want the economy to slow down significantly as a result of further curbs in credit, but further piecemeal restrictions are possible which will raise the cost of borrowing at the margin. By the same token, government spending is likely to rise this year such that the government fails to meet its fiscal deficit target in FY 1995-96 and this higher demand for funds by the government will contribute to a continuation in a back up in lending rates and yields this year. A serious risk for inflation later in 1996 concerns the extent to which the RBI could relent from its tighter monetary policy and accommodate the expansion in government spending in the year leading up to an election.

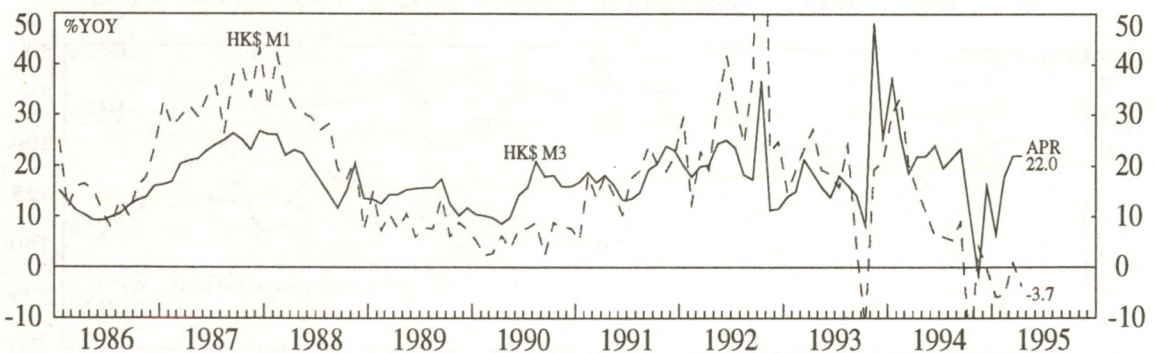
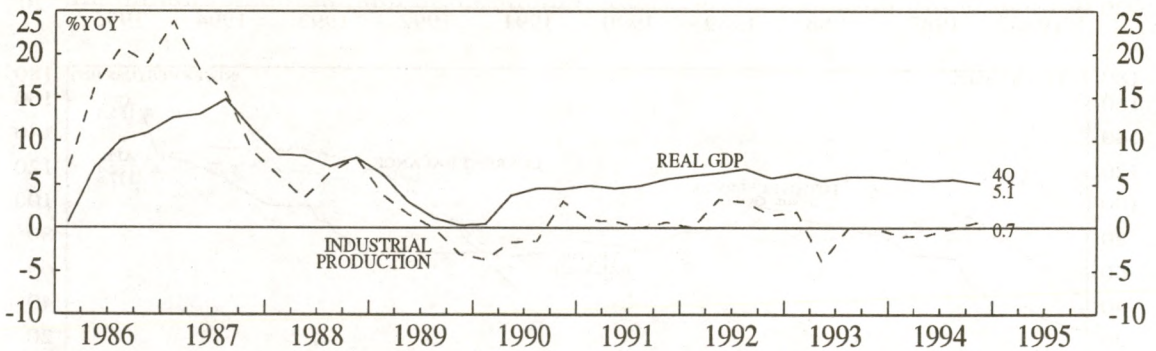
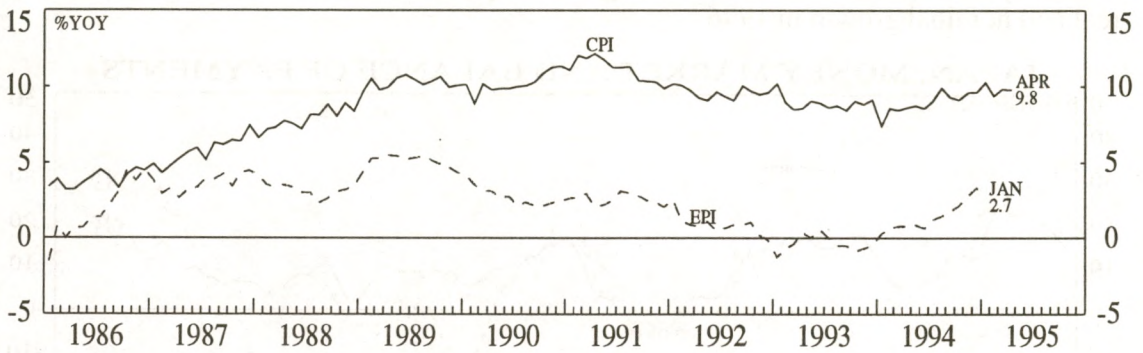
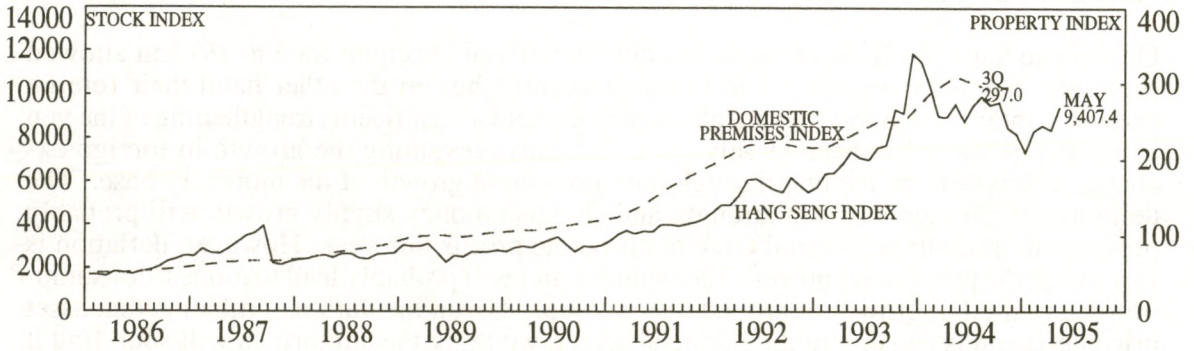
HONG KONG: CONSUMPTION SLOWDOWN

The impact of the higher interest rates in 1994 is feeding through to the real economy via a contraction in consumption indicators. The growth in retail sales volumes has slowed over the last 6-12 months and contributed to a decline in the demand for commercial property such that rents have declined by between 20-25% from the peak around 12 months ago. The labour market remains relatively tight (with unemployment remaining in the 2-3% range) and so wage inflation (especially) in the area of services is keeping the CPI rate close to double digit rates. This situation appears likely to persist while the provision of most services within Hong Kong remains close to full capacity and while China continues to grow rapidly. In the years ahead, as other port and shipping facilities gradually develop in China and as some of the remaining manufacturing firms relocate to cheaper bases within Asia, both the trade and current account (excluding investment income) balances could worsen with the trade balance remaining in deficit. However, shorter term the trade deficit may moderate on the basis that some of the transfer pricing activities by Chinese entities will be reversed if the current tight credit conditions in China are eased.

HONG KONG: MONEY MARKET AND BALANCE OF PAYMENTS



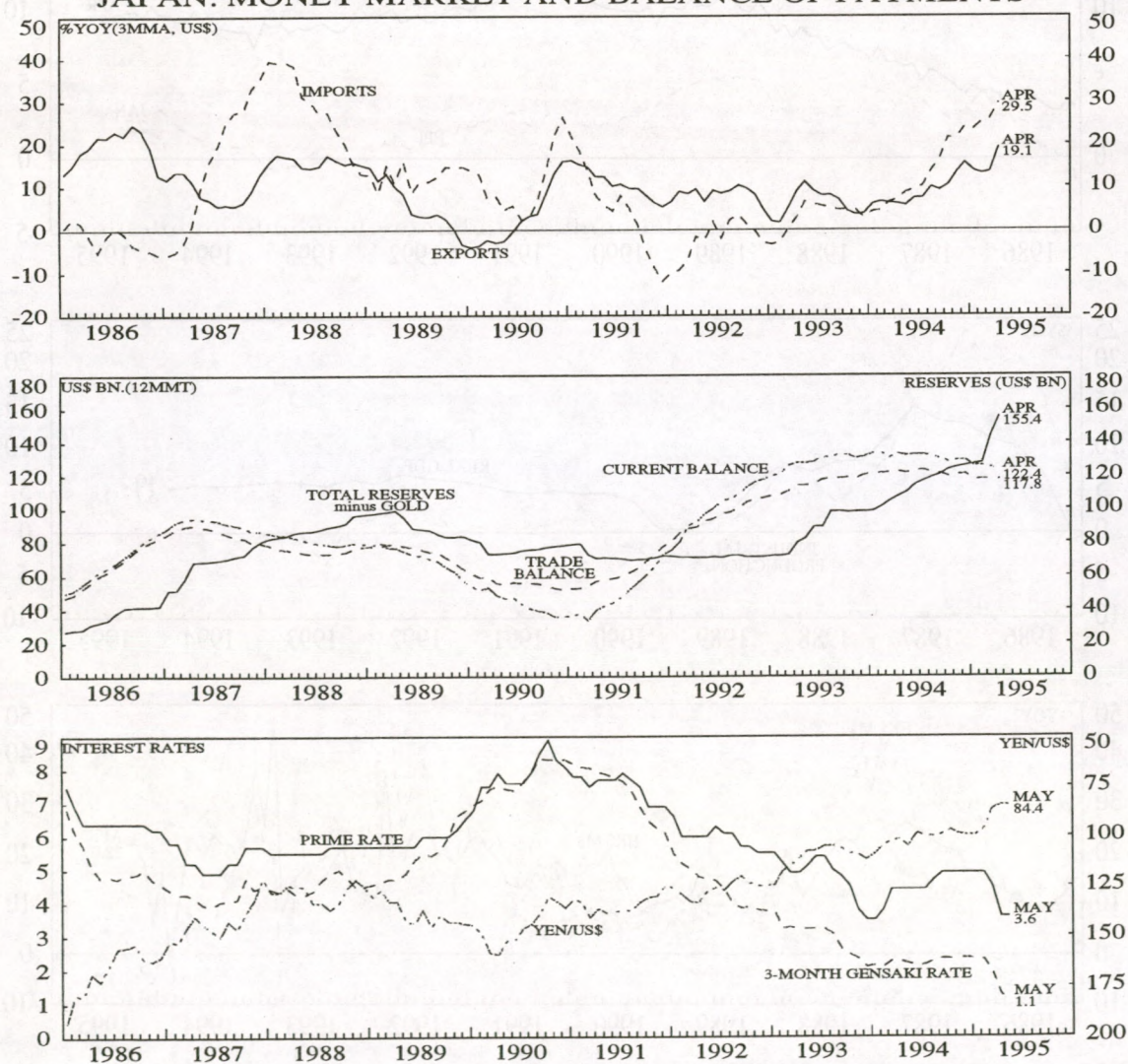
HONG KONG: MONEY, OUTPUT, GOODS AND ASSET PRICES



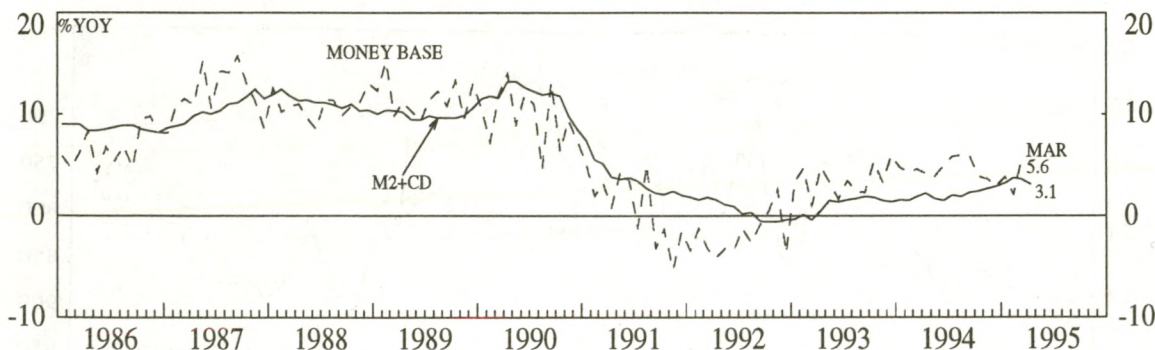
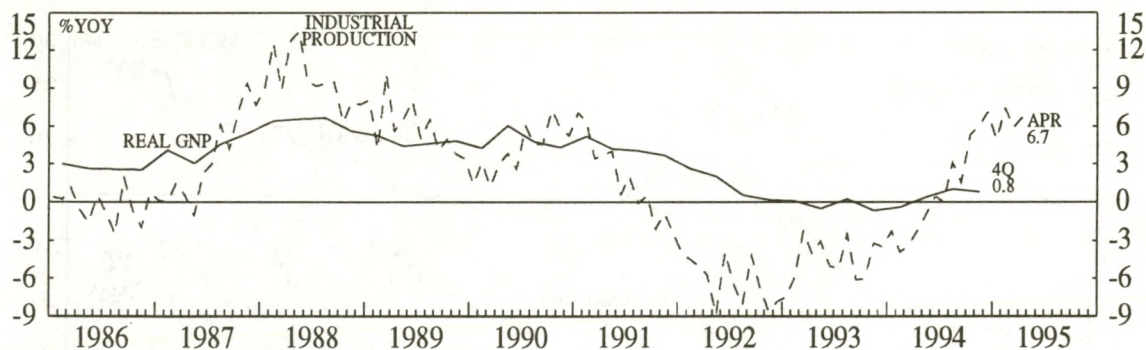
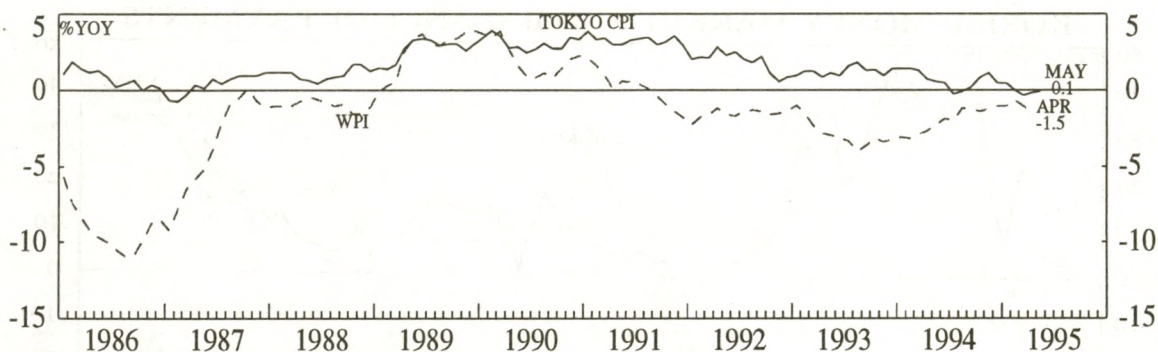
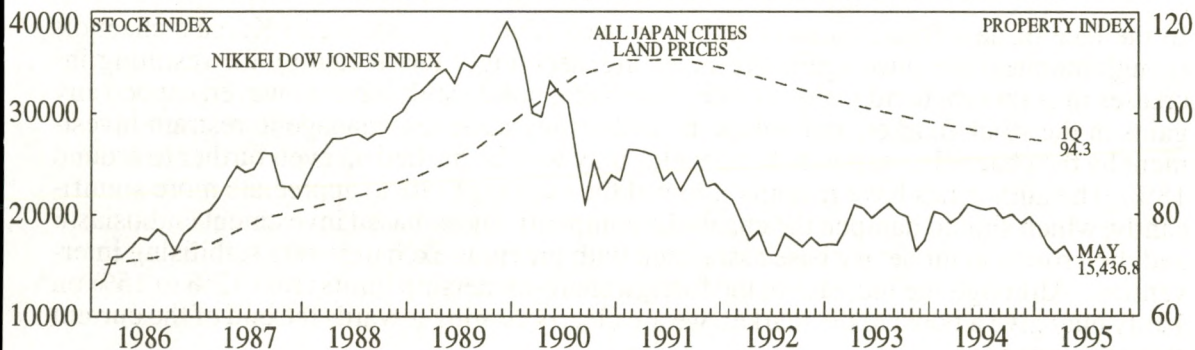
JAPAN: DEFLATION WILL EVENTUALLY PROMPT REFLATION

On the one hand the Bank of Japan has cut the Official Discount Rate to 1% and allowed (nominal) market interest rates to fall significantly, but on the other hand their foreign exchange intervention has been insufficient to prevent a significant strengthening of the yen in early 1994, and has been largely sterilised, thus preventing the growth in foreign exchange reserves from feeding through into more rapid growth of the monetary base. The deflationary pressures of yen-strength and sluggish money supply growth will probably prevent any growth in nominal GDP or corporate profits this year. However, deflation is increasing the purchasing power of consumers, and will probably lead to modest consumption-led real GDP growth of around 1% this year. Given the various problems that asset price deflation is causing in the financial sector, we think the authorities will soon find it necessary to ease monetary conditions significantly. Such a move should facilitate stronger real and nominal growth in 1996.

JAPAN: MONEY MARKET AND BALANCE OF PAYMENTS



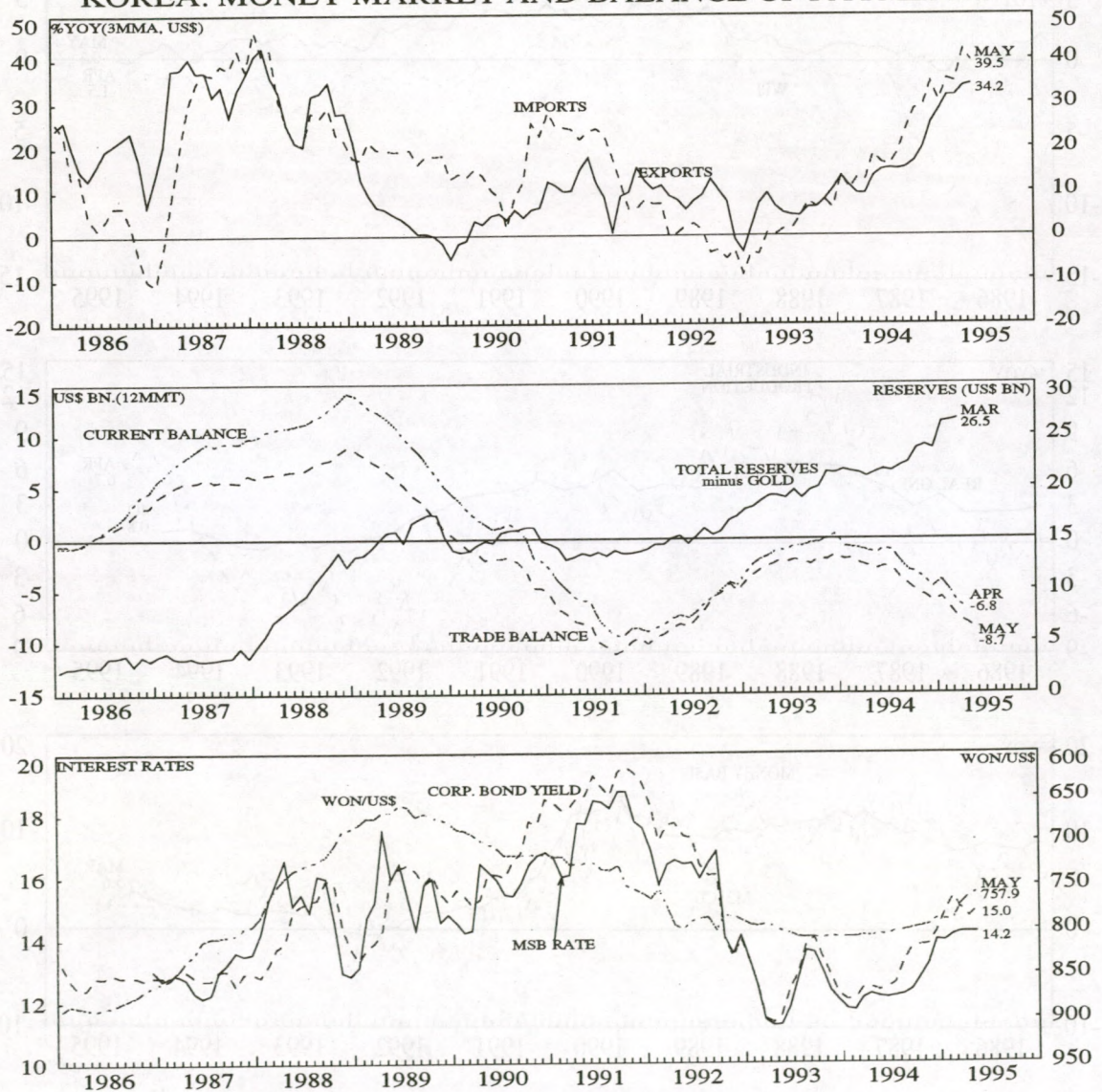
JAPAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



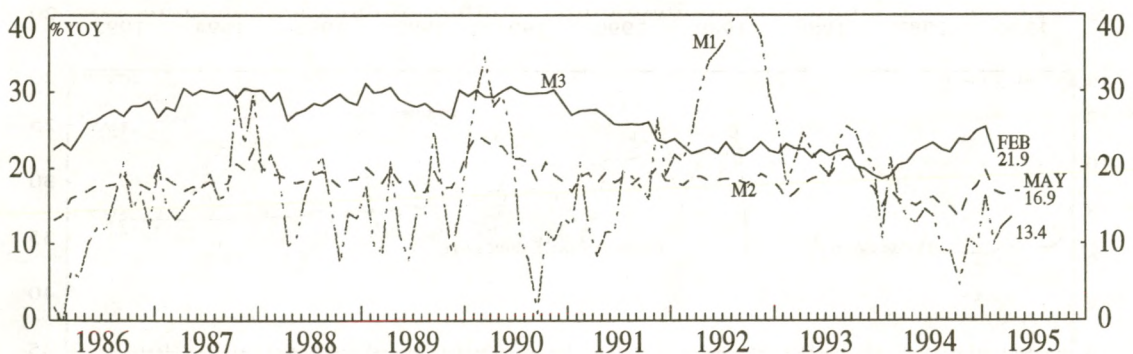
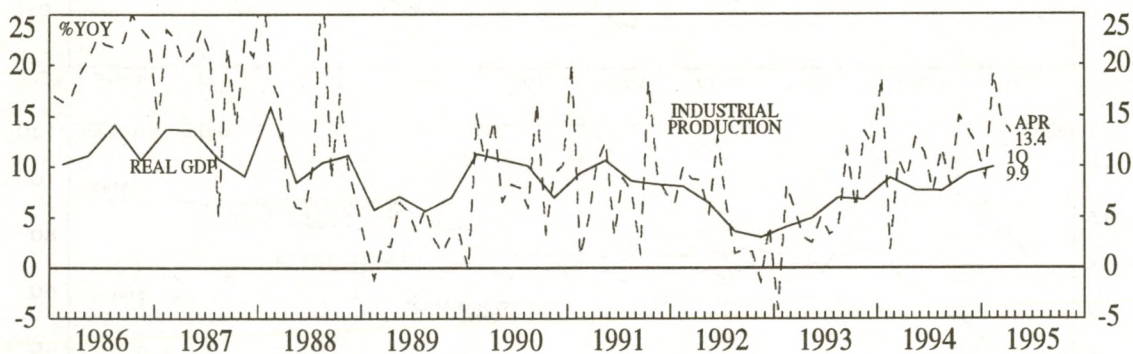
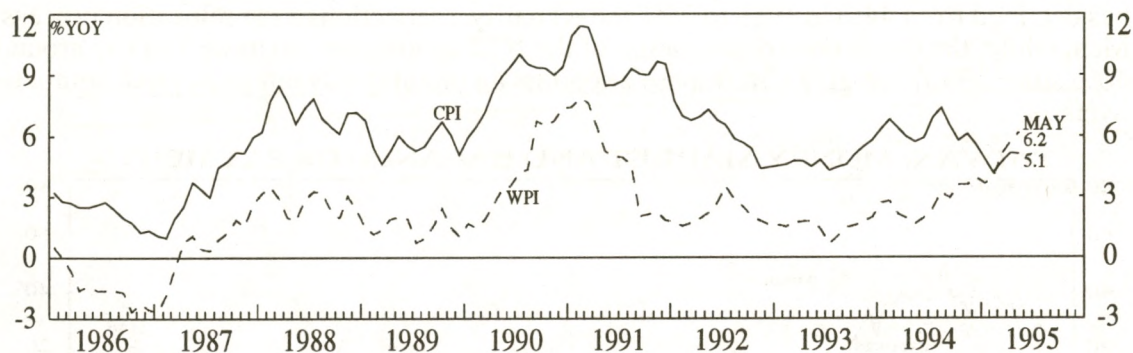
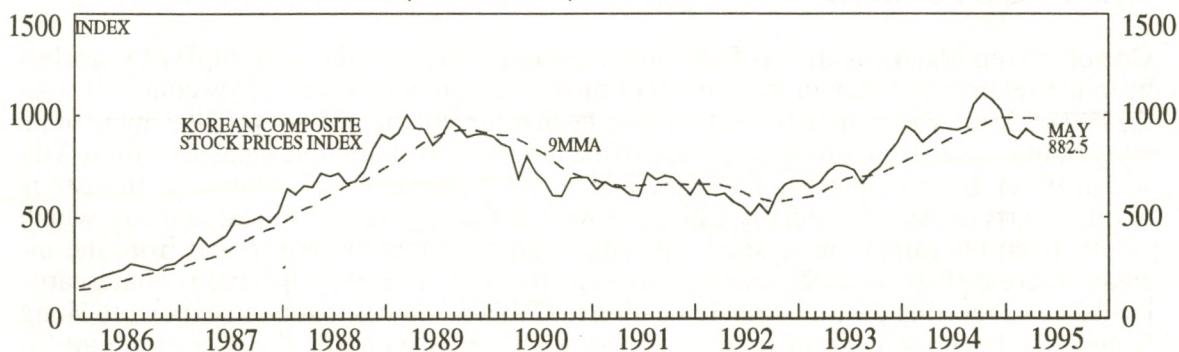
KOREA: OVERINVESTMENT PUSHES UP INTEREST RATES

In the face of new-found export competitiveness (due to yen strength) Korea's chaebols (conglomerates) are once again overinvesting, seemingly unaffected by the resulting increases in corporate bond yields to date. The rising bond yields have, however, capped any gains in the stock market, and unless the authorities somehow manage to restrain investment by the chaebols, corporate bond yields may well be pushed up even further to around 18%. The authorities have recently allowed the exchange rate to appreciate more significantly, which should dampen the chaebols' competitiveness-based investment enthusiasm and the growth in monetary base associated with previous exchange-rate stabilising intervention. Although the increase in the foreign share-ownership limits from 12% to 15% on 1 July may give a boost to the market, we are clearly coming towards the end of the current monetary upswing.

KOREA: MONEY MARKET AND BALANCE OF PAYMENTS



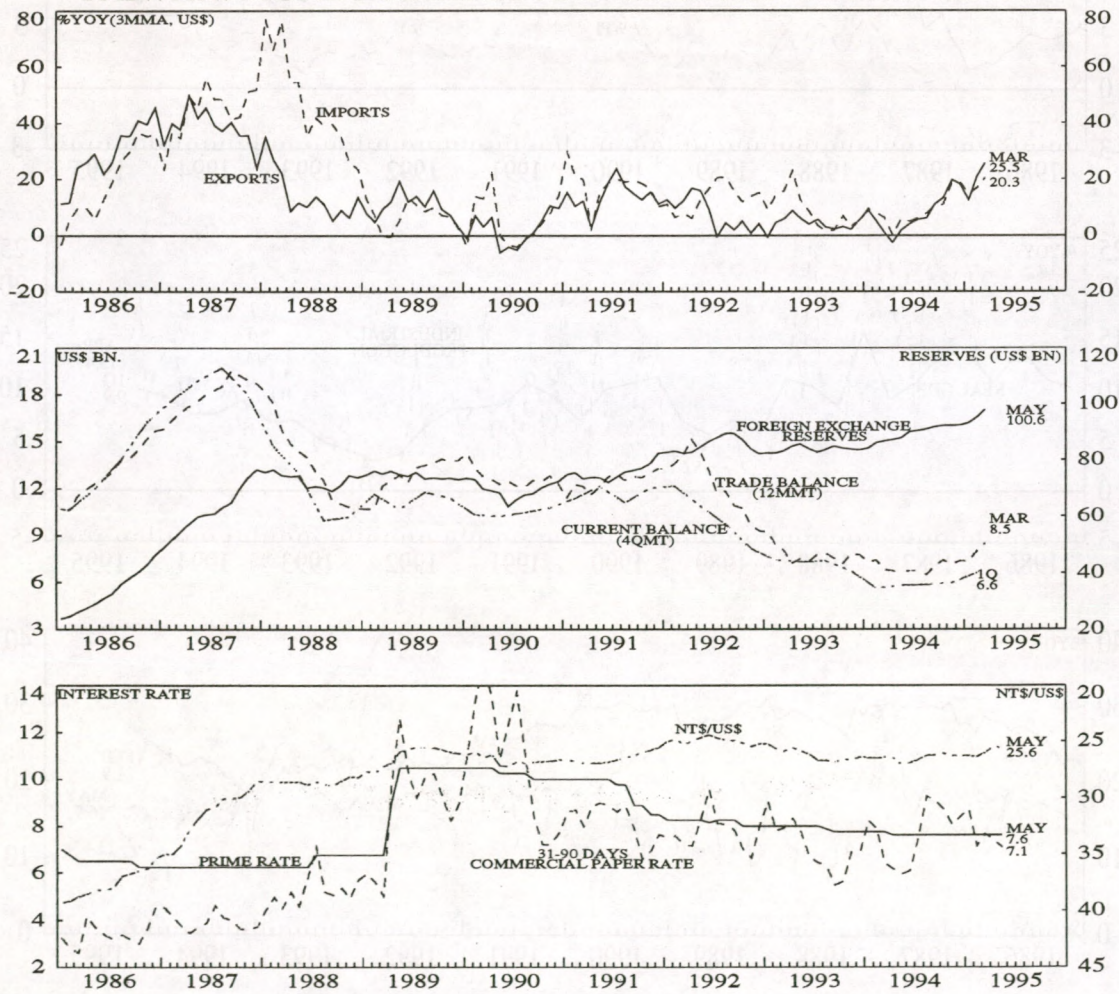
KOREA: MONEY, OUTPUT, GOODS AND ASSET PRICES



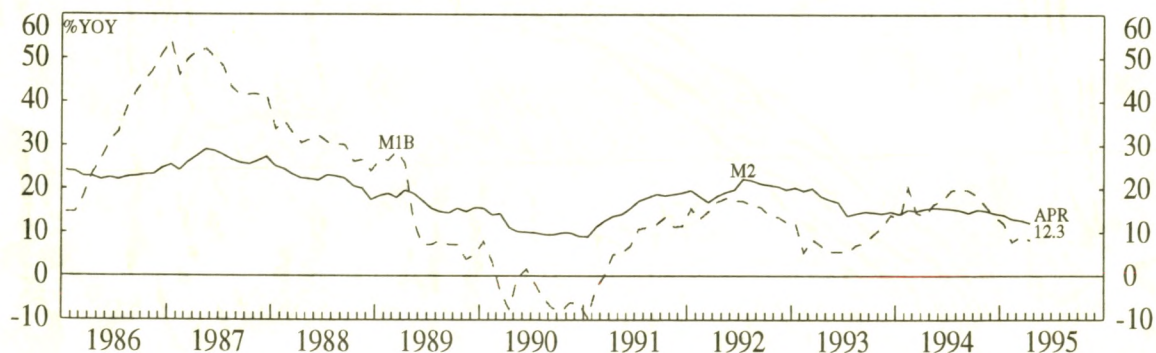
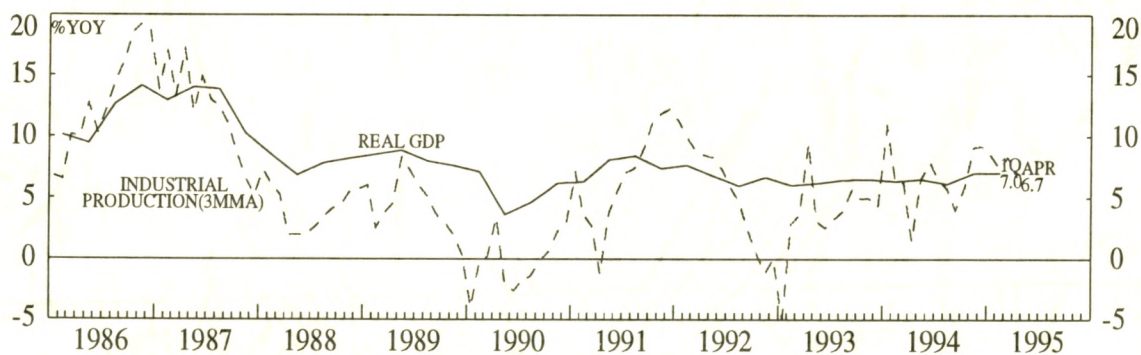
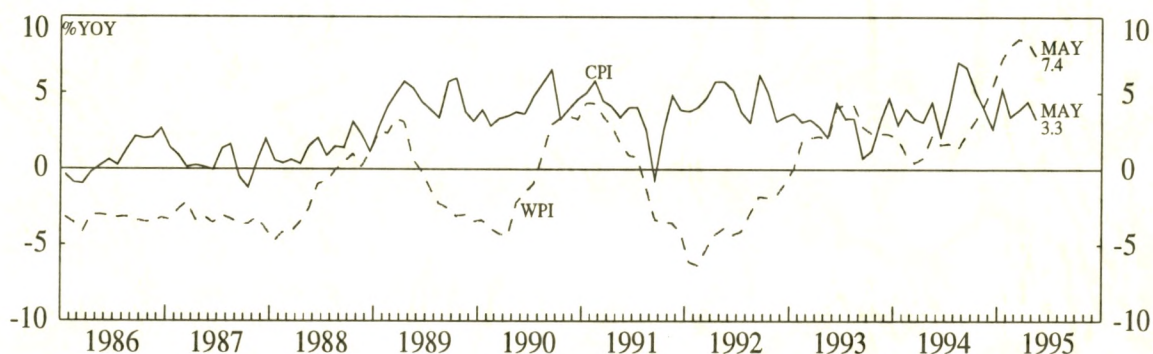
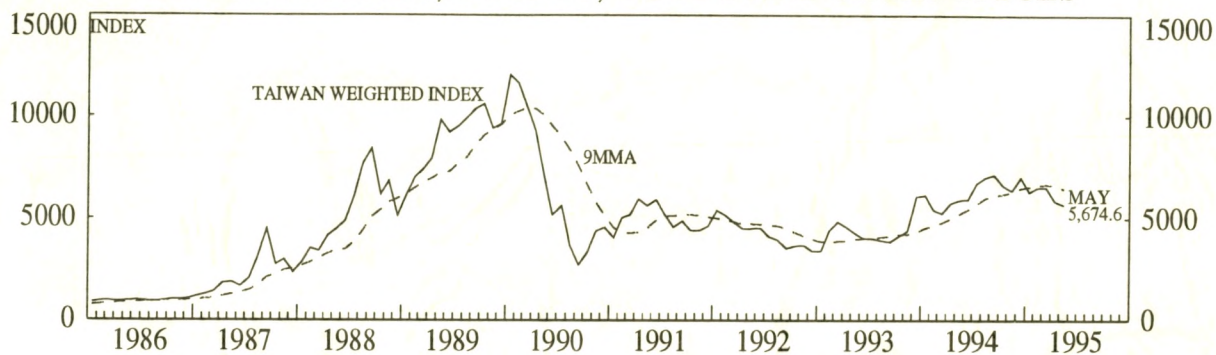
TAIWAN: STEADY GROWTH CONCEALS INDUSTRIAL RESTRUCTURING

One of the remarkable features of the Taiwanese economy over the last couple of years has been the relative stability in the growth of money, output and prices. This contrasts with the rest of Asia, where these indicators have been more volatile. However, like many of its neighbours, Taiwan continues to partake in the longer term qualitative changes within Asia which affect its development. These include the relocation of lower technology industries to other parts of Asia (especially China) as well as the upgrading of local industry which results from the migration of some Japanese manufacturers to Taiwan and from the increase in competitiveness of some local manufactures vis-a-vis their Japanese counterparts. Evidence supporting the industrial relocation to China continues to mount: exports to Hong Kong have been rising steadily over the past eight years such that they now account for around 22% of the total (as compared with 12% in 1990). The share of exports to the US has declined from 44% in 1989 to 26% today; partly a reflection of the relocation process. Meanwhile, the continuous depreciation of the NT\$ against the Japanese Yen (by around 40% since 1990) has given Taiwanese exporters an ongoing advantage in price competitiveness.

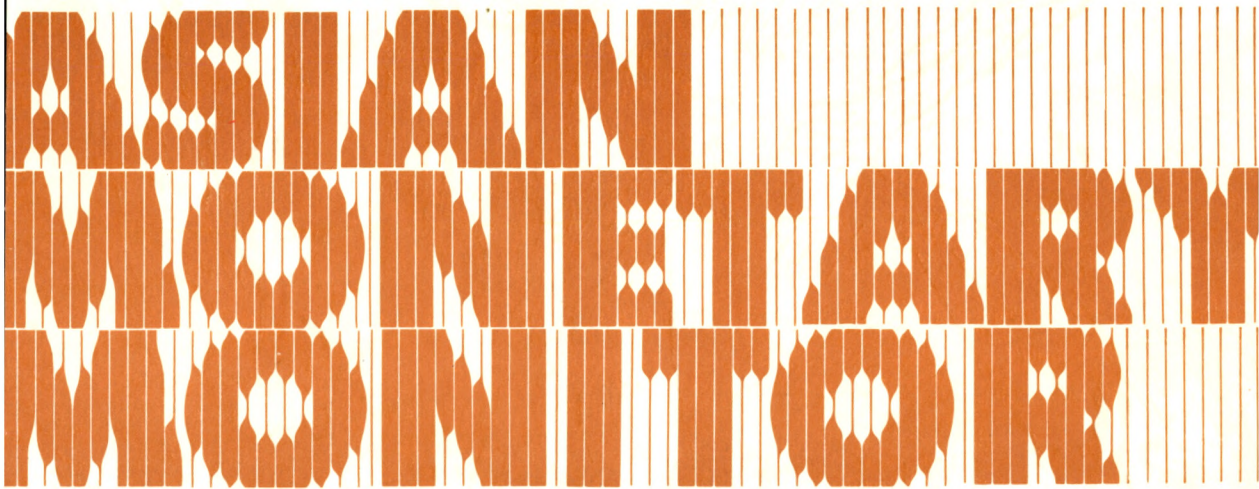
TAIWAN: MONEY MARKET AND BALANCE OF PAYMENTS



TAIWAN: MONEY, OUTPUT, GOODS AND ASSET PRICES







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AUSTRALIA AND NEW ZEALAND STUBBORN INFLATION EXPECTATIONS

Australia and New Zealand have both experienced impressive reductions in their underlying rates of inflation in recent years from around 10% ten years ago to around 2% at present. However, bond yields in both countries have been slower in coming down to reflect what the authorities claim to be a permanent reduction in the inflation rate. Comparing the two countries, we find that New Zealand has had greater reductions in both the inflation rate and in bond yields. Bond yields can be thought of as nominal long term interest rates, i.e. the real long term interest rates less long term inflation expectations (both of which are unobservable¹). Economic theory suggests that real long term interest rate should equalise between countries with open capital accounts, and evidence from the UK index-linked gilts market suggests that the real long-term interest rate has remained broadly constant at around 3.8% over the past 10 years². Assuming a relatively constant global real interest rate, the current premium on Australia's nominal long-term interest rate (the bond yield) over that of New Zealand, along with the recent appreciation of the NZ\$ with respect to the A\$, suggests that New Zealand has been more successful in establishing anti-inflation credibility and reducing inflationary expectations, at least in the eyes of financial markets.

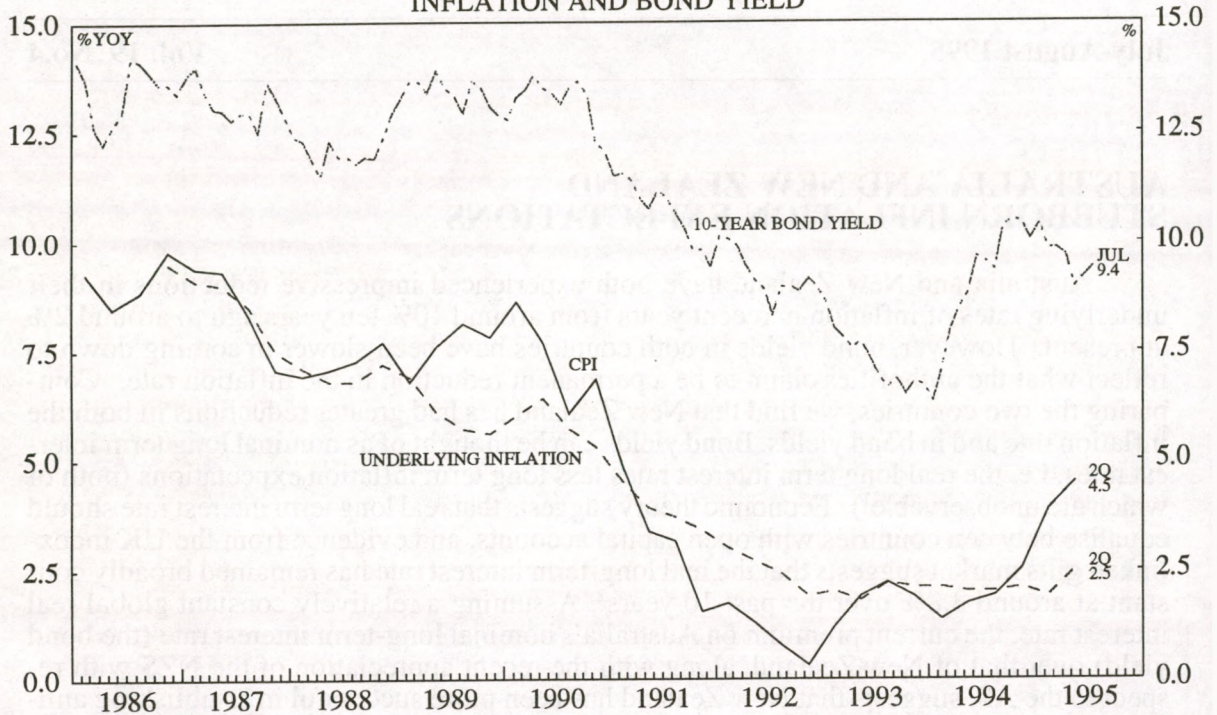
This raises a number of questions. Why are financial markets' inflationary expectations still so much higher than actual inflation? Are market expectations wrong (backward-looking, upward-biased and/or downwardly sticky) or are there still reasons to be sceptical of the relatively recent conversion (by Bundesbank standards) of the two countries to the pursuit of low inflation? Why are inflationary expectations in Australia so much higher than in New Zealand, in spite of their (currently) similar underlying rates of inflation? What factors is that difference in inflationary expectations and anti-inflation policy credibility based on, and is it justified? What, if any, lessons can be drawn from the Australian and New Zealand experience for other countries wishing to reduce inflationary expectations and enhance their anti-inflation policy credibility.

¹ Although both Australia and New Zealand have index-linked bond markets, these are fairly recent, and have not been sufficiently liquid to justify their use in historical analysis of bond yields. Although surveys provide some clue to expectations, they may suffer from sample bias.

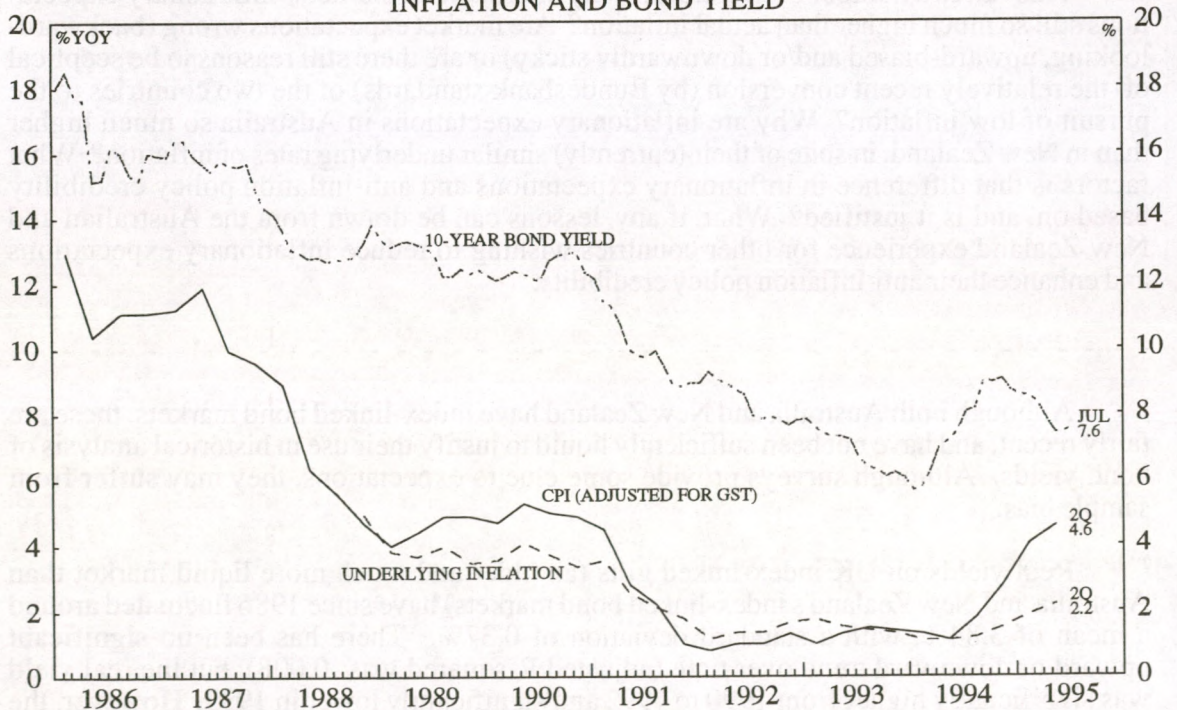
² Real yields on UK index-linked gilts (an older and much more liquid market than Australia and New Zealand's index-linked bond markets) have since 1986 fluctuated around a mean of 3.84%, with a standard deviation of 0.37%. There has been no significant upward or downward trend over time (adjusted R-squared was -0.008), but the real yield was significantly higher from 1990 to 1992 and significantly lower in 1993. However, the minimum (2.86) and maximum (4.72) values were not extreme at only 2.6 and 2.4 standard deviations away from the mean respectively.

ASIAN MONETARY MONITOR

AUSTRALIA: CHART 1
INFLATION AND BOND YIELD



NEW ZEALAND: CHART 2
INFLATION AND BOND YIELD



Bond yields and inflation

Historically, have the inflation expectations embedded in bond yields provided a good guide to future inflation? How do bond yields compare with other fairly simple models of inflation. Table 1 shows the regression results for four simple models of inflation based on the following explanatory variables (all lagged 12 months): (i) bond yields, (ii) inflation itself, (iii) the growth rate of broad money, and (iv) broad money growth (M) and the rate of change of the nominal effective exchange rate (e). The results for Australia show that bond yields have been worse at predicting inflation a year hence than all the other models, with model (iv) based on broad money growth and changes in the nominal effective exchange rate being the best of the four models. Bond yields in New Zealand were a slightly more effective predictor of inflation, and the monetary models of inflation did not work nearly as well in New Zealand's case. The large negative intercept term in the bond yield based inflation models for both Australia and New Zealand also indicates that the difference between bond yields and future inflation has been consistently higher than the global level of real interest rates indicated by the UK index-linked gilts market³, suggesting that Australian and New Zealand bond markets have persistently over-estimated future inflation.

Table 1

Country and model	Intercept	Explanatory variable(s)	Adjusted R-squared	Durbin-Watson
Australia (i)	-5.82 (3.21)	0.95 (6.22)	0.51	0.19
(ii)	0.82 (1.19)	0.79 (7.32)	0.59	0.36
(iii)	0.99 (2.15)	0.48 (10.9)	0.76	0.38
(iv) M	0.72 (1.60)	0.49 (11.6)	0.79	0.49
e		-0.05 (2.20)		
NZ (i)	-5.12 (4.23)	0.82 (8.67)	0.67	0.29
(ii)	0.76 (1.62)	0.67 (11.1)	0.77	0.59
(iii)	0.27 (0.37)	0.38 (7.27)	0.58	0.38
(iv) M	0.24 (0.32)	0.37 (7.17)	0.58	0.39
e		-0.03 (0.62)		

(t-values in brackets)

If the bond market has been such a poor predictor of inflation, is it perhaps because inflationary expectations are based on current inflation and historical inflationary experience rather than on a forwardlooking model based on a wider range of economic factors? We tried to model bond yields on inflation with various time lags, and found that a combination of time lags from the preceding two years provided a reasonably good model of inflation, suggesting that inflationary experience plays a substantial part in determination of bond yields. Another important factor is the global inflation environment and global real interest rate embodied in global bond yields. Putting these factors together we have modelled 10-year Australian and New Zealand government bond yields (Y_t) on 10-year US Treasury bond yields (Y^*) and local inflation expectations (P_t^*).

³ Various institutional factors in the UK, e.g. the need for pension funds to show actuarially that their assets will yield sufficiently high and stable real returns to meet future liabilities, has probably helped boost demand for index-linked gilts, and pushed index-linked gilt yields slightly below "the global" long-term real interest rate.

$$Y_t = a + b Y_t^* + c P_t^* + u_t \quad (\text{Equation 1})$$

Local inflation expectations have been modelled according to Cagan's adaptive expectations model based on actual inflation:

$$P_t^* - P_{t-1}^* = \gamma (P_t - P_{t-1}^*); \text{ where } 0 < \gamma < 1 \quad (\text{Equation 2})$$

where γ is the expectations coefficient. If $\gamma = 1$, expectations adjust instantaneously to a change in inflation, while a γ close to 0 suggests that expectations are more backward looking and adjust only slowly. Solving equation 1 for P_t^* , we get:

$$P_t^* = -a/c + 1/c Y_t - b/c Y_t^* - u_t/c \quad (\text{Equation 3})$$

Substituting equation 3 into equation 2 we get:

$$\begin{aligned} & (-a/c + 1/c Y_t - b/c Y_t^* - u_t/c) - (-a/c + 1/c Y_{t-1} - b/c Y_{t-1}^* - u_{t-1}/c) \\ & = \gamma [P_t - (-a/c + 1/c Y_{t-1} - b/c Y_{t-1}^* - u_{t-1}/c)] \end{aligned} \quad (\text{Equation 4})$$

Collecting terms we find

$$Y_t = (a + bY_t^* + b(\gamma-1)Y_{t-1}^* + \gamma c P_t + (1-\gamma) Y_{t-1} + [u_t - (1-\gamma) u_{t-1}]) \quad (\text{Equation 5})$$

The main drawbacks to this reduced form model are that both γ and b are overidentified, and that the resulting error term is auto-correlated. The main advantage is its ability to model otherwise unobservable inflation expectations. The regression results for Australia and New Zealand are shown in table 2:

Table 2: Regression results Adaptive Expectations Bond Yield model

$$\text{Australia: } Y_t = 0.376 + 0.494 Y_t^* - 0.327 Y_{t-1}^* + 0.084 P_t + 0.809 Y_{t-1}$$

(0.99) (3.55) (2.24) (2.66) (14.5)

$$\text{autoregression coefficient} = 0.118 \quad \text{Adjusted } R^2 = 0.969$$

(0.86)

$$\text{New Zealand: } Y_t = -0.446 + 0.108 Y_t^* + 0.146 Y_{t-1}^* + 0.124 P_t + 0.806 Y_{t-1}$$

(1.09) (0.74) (0.98) (3.30) (16.2)

$$\text{autoregression coefficient} = 0.276 \quad \text{Adjusted } R^2 = 0.986$$

(2.06)

(t-values in brackets)

The main results from the model are that the various estimates of the adjustment coefficient γ (derived from the statistically significant coefficients in the reduced form equation) range from 0.11 to 0.33, which, along with the low coefficient for inflation, suggests that the bond markets' inflation expectations adapt only relatively slowly (and perhaps never fully) to changes in inflation rates. Spreadsheet simulation using these coefficients suggest that inflation expectations are still adjusting to the falls in inflation that we have seen in Australia and New Zealand over the past few years.

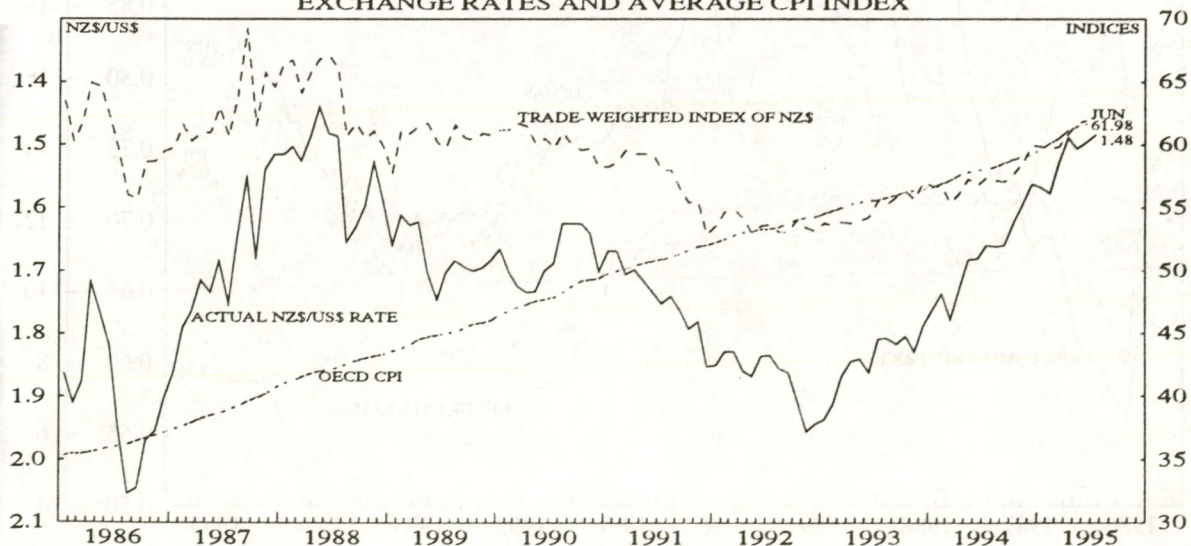
Another interesting finding is the low t-values for US bond yields in the New Zealand bond yield model (and the wrong sign for the lagged value), compared to the statistically significant (and correctly signed) t-values for US bond yields in the Australian model. A re-estimation of the New Zealand model without US bond yields yielded similar reduced form coefficients for the other variables. Correlation coefficients between Australian, New Zealand and US bond markets tend to lend further support to the idea that New Zealand bonds are less directly influenced by US bond markets than Australian bonds. Another major difference between bond yield models for Australia and New Zealand is in the coefficient for inflation, which is almost 1 1/2 times higher in New Zealand than in Australia. This suggests that inflation expectations have adjusted slightly less slowly to changes in inflation in New Zealand than in Australia.

Different Monetary Policy Frameworks

The reasons for the different degrees of success in reducing inflationary expectations can in large part be found in the different monetary policy frameworks of the two economies. The Reserve Bank of New Zealand (RBNZ) Act of 1989 clearly lays down price stability as the sole objective of monetary policy, provides for transparency in defining this target and gives the Reserve Bank independence to implement policy. The objectives of monetary policy in Australia, on the other hand, are aimed at a more vaguely defined objective of low inflation with growth compatible with full employment over the course of the economic cycle; and the Reserve Bank of Australia (RBA) has no statutory independence for implementing monetary policy.

The choice of operational targets, and undoubtedly part of the relative success of recent anti-inflation policies, reflects the different relative size and openness (trade dependence) of the two economies. Imported items account (directly or indirectly) for over half of New Zealand's consumer price index, but only for a much smaller proportion of Australia's CPI. Not surprisingly, the main operational target of the RBNZ's anti-inflation policy has for the past few years been the gradual appreciation of the Trade Weighted Index (TWI) of the New Zealand dollar in line with projected inflation rates in major trading partners (see Chart 3).

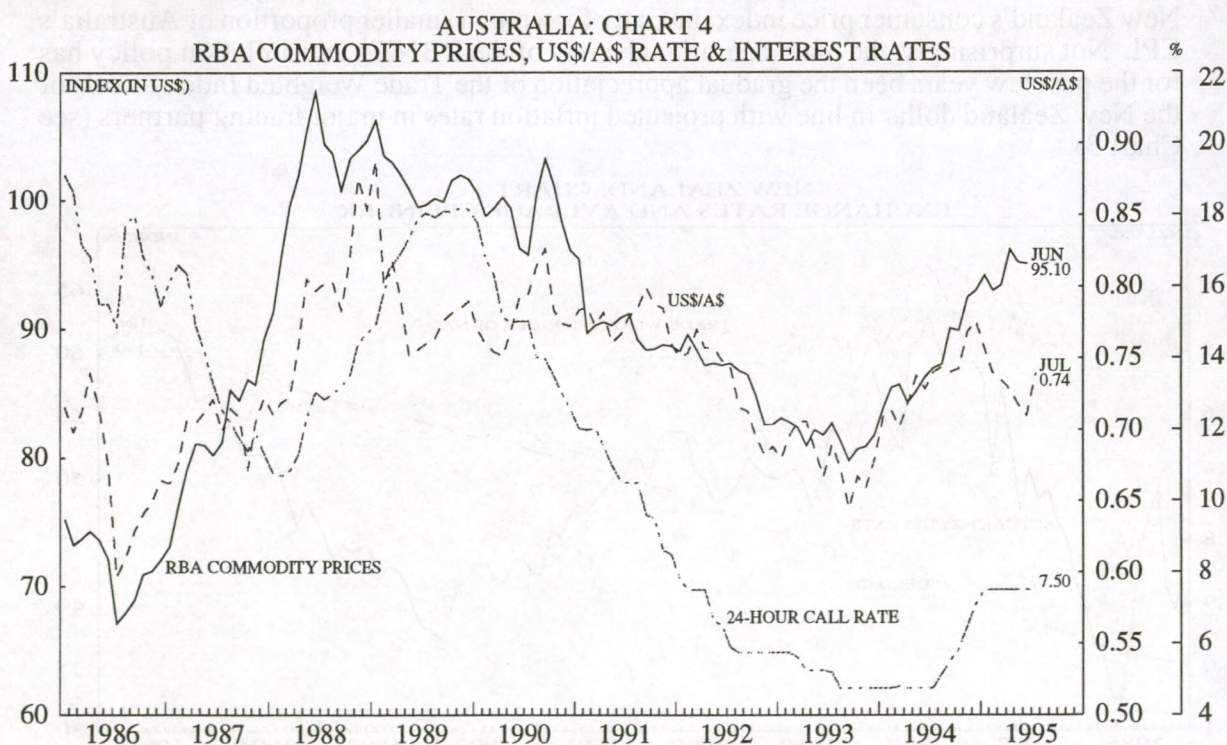
NEW ZEALAND: CHART 3
EXCHANGE RATES AND AVERAGE CPI INDEX



The projected track of the TWI is laid out transparently in the six-monthly monetary policy statements required by the RBNZ Act. The RBNZ's day to day open market operations are aimed at achieving a target level of cash in the system. When the RBNZ wishes to tighten (or loosen) monetary policy, this is most often done through the use of 'open mouth operations', i.e. RBNZ statements on monetary policy to guide the level of market interest rates. Such statements are backed up by the credible implied threat that the RBNZ can alter the daily cash target to squeeze (or flood) the banking system, and has done so on several occasions.

Although there is a historical correlation between Australia's exchange rate and the RBA commodity price index (see chart 4), this is more a function of the high proportion of commodities in Australia's exports than of any successful implementation of exchange rate targeting. The RBA's main operational target is a fixed overnight cash rate, with interest rates in longer maturities and the exchange rate allowed to fluctuate in line with market conditions, although these other rates along with economic data forms the basis for policy formulation and changes to the cash rate (i.e. to monetary policy). Despite the lack of a clearly defined anti-inflation mandate and statutory independence, the RBA manages to hold significant sway with the markets, as evidenced by the effectiveness of the sharp monetary tightening in late 1994 (see below).

Besides the different frameworks for monetary policy formulation and implementation, the two countries face very different constraints on government finances and on the balance of payments. Australia is still running a budget deficit of (depending on definition) upto 2.5% of GDP, with much of the apparent fiscal tightening in the May 1995 budget achieved through tax increases and asset sales rather than cost-cutting. New Zealand's government, on the other hand, is running a sustainable and rising operating surplus, plans



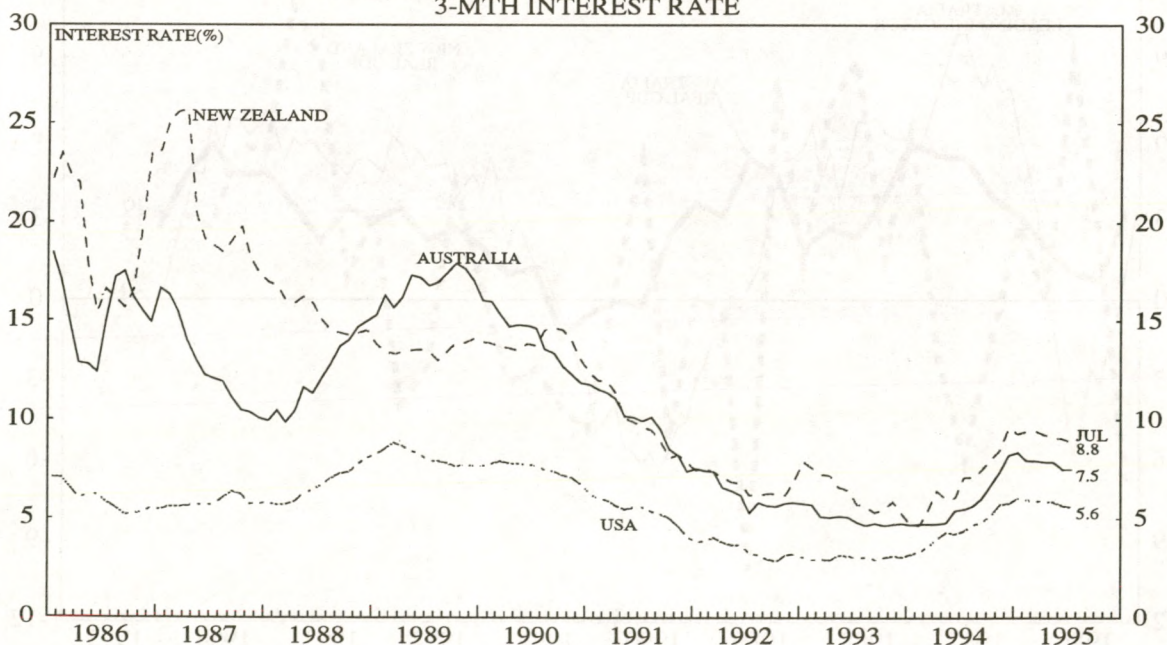
to pay off the net foreign currency debt by 1997, and has spare room to cut taxes in the next 2-3 years. In other words, New Zealand has no fiscal deficit for monetary policy to accommodate, and a declining debt burden which provides little temptation for monetisation. On the balance of payments, Australia's current account deficit is widening towards 6% of GDP, while that of New Zealand is a more modest 2.6% of GDP. New Zealand's healthier current account makes it easier (and hence more credible) to pursue anti-inflation policies involving proactive exchange rate appreciation and flexible interest rate adjustments.

In the final analysis, however, any monetary policy framework depends on credibility. The RBNZ derives some part of its credibility from the RBNZ act, but the improvements in New Zealand's economic structure reaped from a decade of microeconomic reform is at least as (if not more) important. Australia's current efforts at micro-reform and deficit reductions will be just as important as any changes to the monetary policy framework in improving anti-inflation policy credibility and lowering inflationary expectations. Credibility is also gained from historical performance, and both Australia and New Zealand have had experiences of double-digit inflation in living memory. The RBNZ Act is probably still too young to be said to have stood the test of time; the RBNZ has only twice made good its threat to alter the daily cash target, and probably needs to pass further tests its credibility with flying colours before its name will be mentioned alongside that of the Bundesbank.

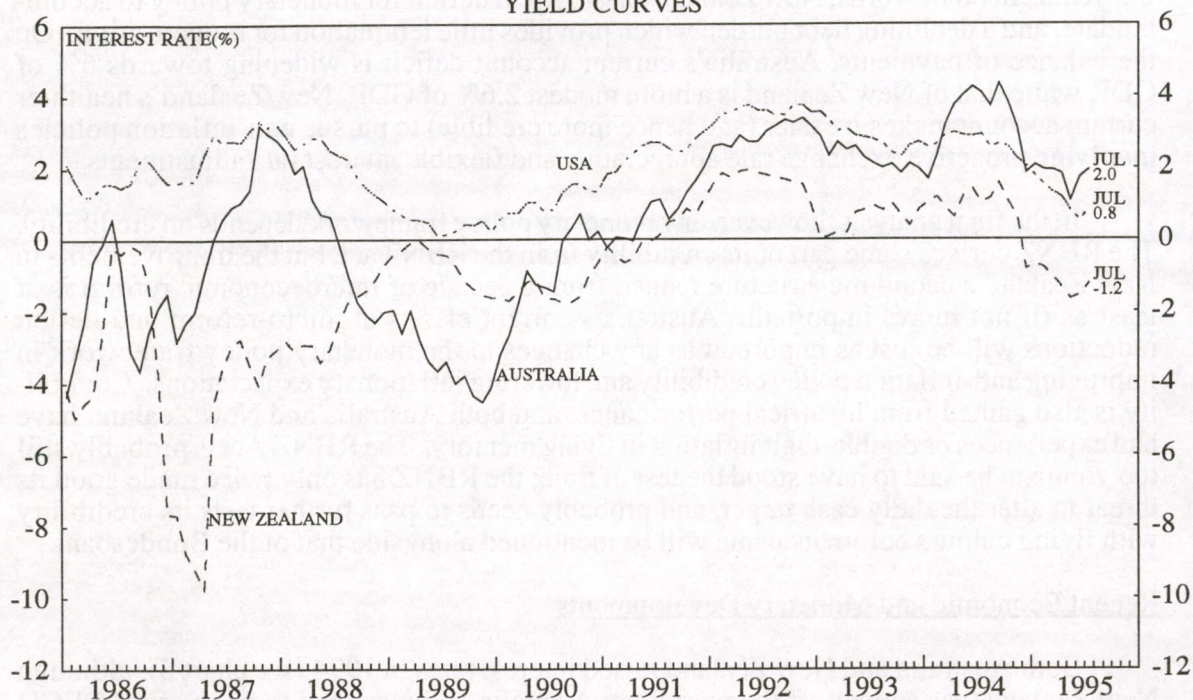
Recent Economic and Monetary Developments

Both Australia and New Zealand raised interest rates in 1994 (see chart 5), although New Zealand was sooner off the mark than Australia and managed to be the first OECD country with an inverted yield curve in the current cycle (see chart 6). The monetary tightening in both countries has succeeded in dampening the acceleration in both the underlying rates of inflation and the rate of real GDP growth, with the index of leading indicators indicating further slowdown ahead (see chart 7).

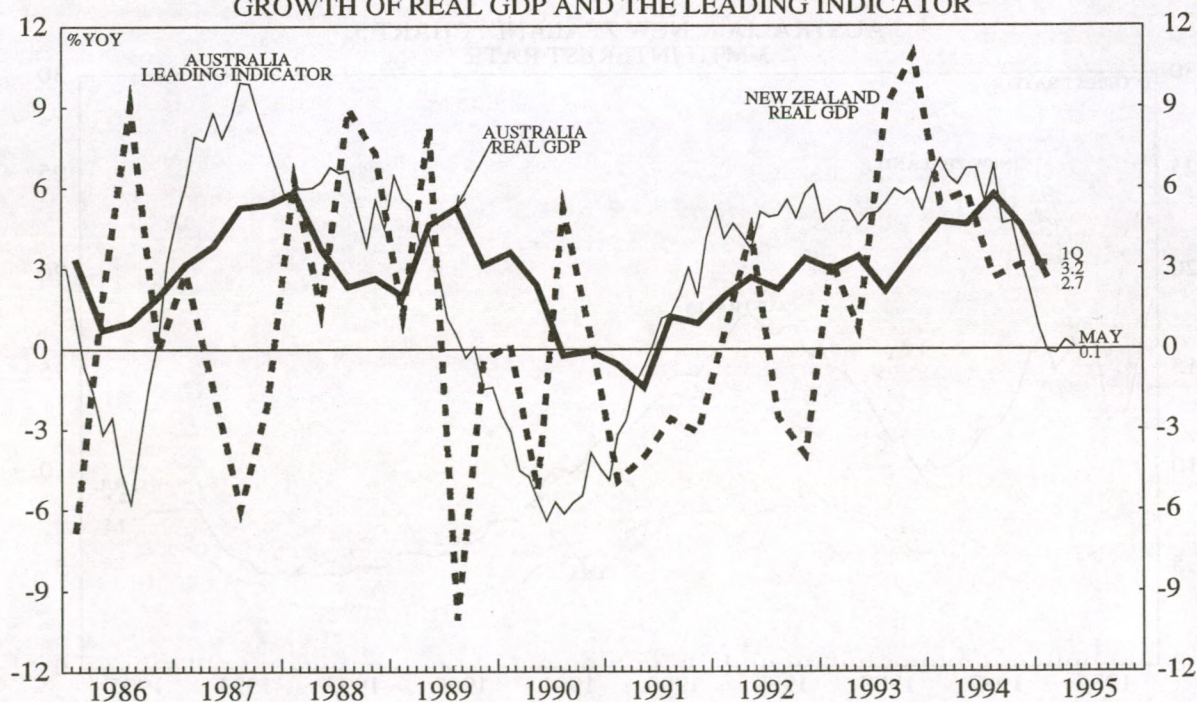
AUSTRALIA & NEW ZEALAND: CHART 5
3-MTH INTEREST RATE



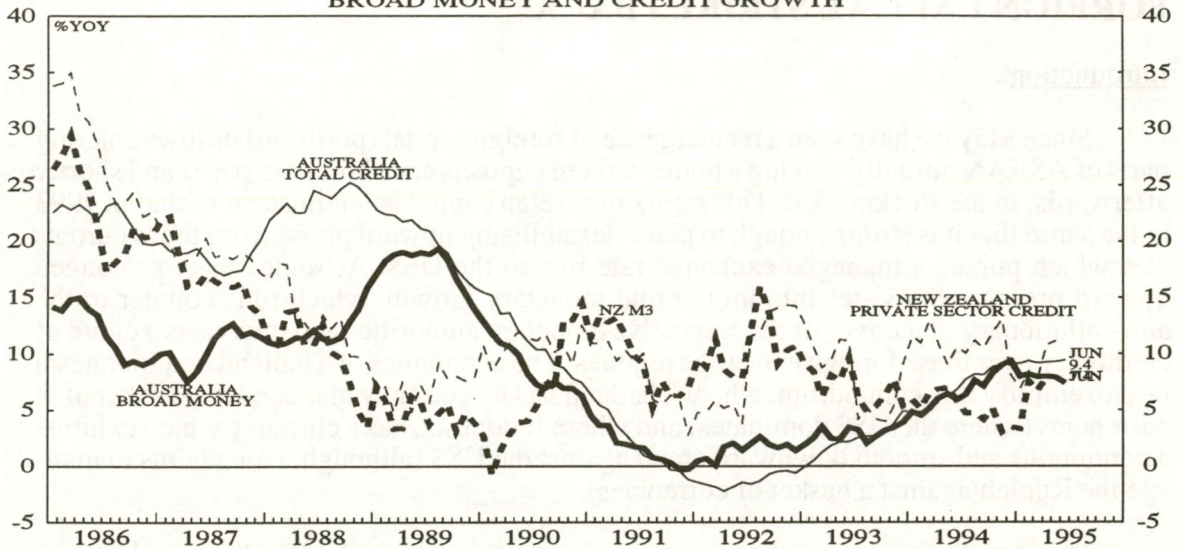
AUSTRALIA & NEW ZEALAND: CHART 6
YIELD CURVES



AUSTRALIA & NEW ZEALAND: CHART 7
GROWTH OF REAL GDP AND THE LEADING INDICATOR



AUSTRALIA & NEW ZEALAND: CHART 8
BROAD MONEY AND CREDIT GROWTH



In Australia in particular, the rapid deceleration in underlying inflation (to 1.9% year-on-year in the first quarter, the same rate as in New Zealand) took most analysts by surprise. The rapid effect of the monetary tightening probably resulted from a combination of the announcement effect on fears of even higher rates, and the increased interest rate sensitivity of a more indebted personal sector. Unfortunately, insofar as the announcement effect relied on constructive ambiguity over the future direction of interest rates, it may well have been undermined by statements accompanying the supposedly tight May 1995 budget suggesting that fiscal tightening had obviated the need for further interest rate increases. Also, the higher underlying inflation rate for the second quarter (2.5% yoy) casts doubt on the significance of the first quarter figure.

The growth rates of broad money and credit in both Australia have stabilised at growth rates compatible with a stabilising of nominal activity. Within these aggregates, there has been a significant slowdown in credit granted for housing, but continued growth in credit for business, suggesting that Australia may well achieve a soft landing this time. In New Zealand, although the stance of monetary policy (as indicated by the high real short-term interest rates, the rapid exchange rate appreciation and the steeply inverted yield curve) tightened severely over the past year, broad money growth has (save for volatility and base effects) been relatively stable. The Auckland real-estate boom (the RBNZ's main domestic inflation concern) appears to be losing some steam, and the futures market has since April been pricing in a decline in 3 month bank bill rates to between 8% and 8.5% by December 1995.

SUMMARY AND CONCLUSIONS: Both Australia and New Zealand have made substantial progress in reducing inflation, although this progress has yet to be fully reflected in bond market inflation expectations, which (as shown in our adaptive expectations model) adapt only sluggishly in response to historical experience of inflation. Given the differences in monetary policy frameworks and in fiscal and external (im)balances, the RBNZ has been accorded with a higher degree of anti-inflation policy credibility than the RBA. In other words, although both countries have made progress there appears to be a slightly lower risk in New Zealand than in Australia for politically motivated interest rate cuts, deterioration in government finances, and/or balance of payments problems.

INDONESIA FOREIGN CAPITAL STRIKES BACK

Introduction

Since May we have seen a reemergence of foreign capital (portfolio) inflows entering parts of ASEAN, initially seeking a home in fixed deposits and short term paper and shortly afterwards, in the stockmarket. This influx of foreign capital is reminiscent of that in 1993 in the sense that it is strong enough to place destabilising upward pressure on those currencies which pursue a managed exchange rate rule to the US\$. At some stage, prolonged upward pressure translates into more rapid monetary growth, which runs counter to the anti-inflationary objectives of the respective monetary authorities and thus casts a cloud of credibility over these foreign exchange regimes. The economies of Thailand and Indonesia best exemplify this conundrum, where Thailand has its currency managed to a basket of 8 currencies (where the US\$ dominates) and where Indonesia, has a currency which exhibits a continuous and smooth downward crawl against the US\$ (although it too claims to manage the Rupiah against a basket of currencies).

This article focuses on the monetary situation developing in Indonesia where the monetary authorities are conducting (mildly stimulative) sterilised foreign exchange intervention to limit the expansion in the money supply and declines in interest rates, while adhering to their exchange rate policy. However, the experience of Bank Negara Malaysia almost two years ago has shown how difficult this is (albeit in a less transparent environment) without resorting to capital controls and/or raising the cost of intermediation (say by raising reserve requirements). If as we expect, the Indonesian authorities adhere to their managed exchange rate rule and retain a capital account relatively free of controls, then attempting to rein in credit growth by imposing quantitative measures (such as higher or more broadly defined reserve requirements) becomes a real possibility, as has recently occurred in Thailand.

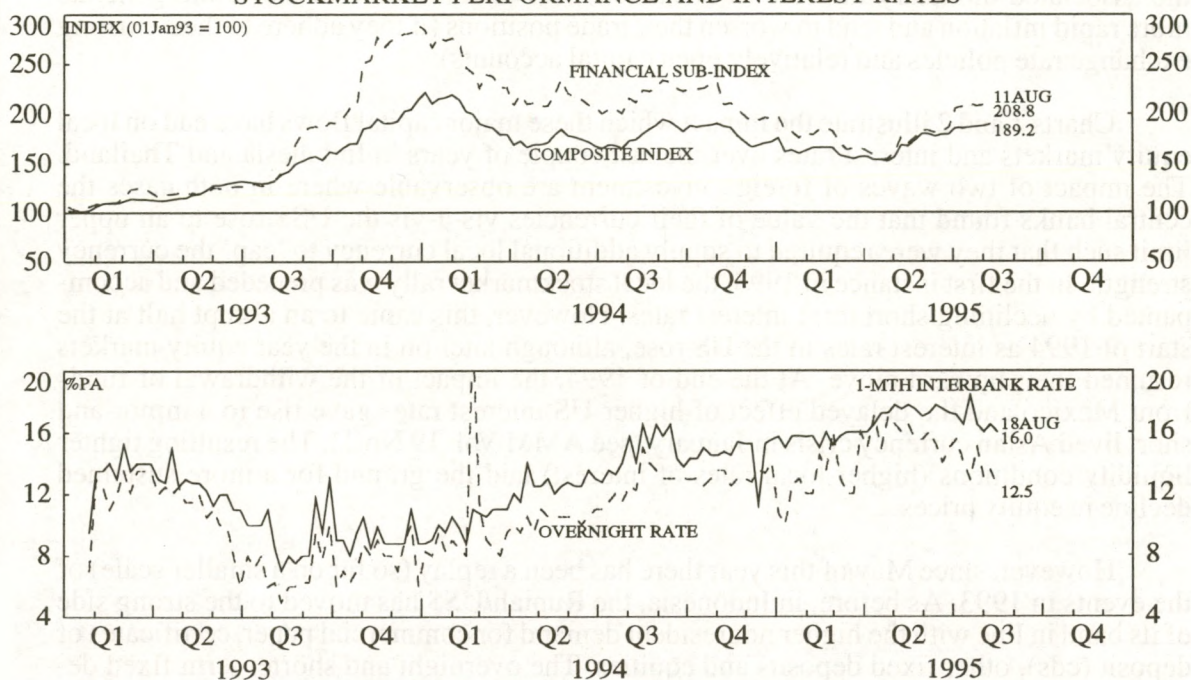
This action obviously carries negative implications for banking stocks in the equity market. However, if the outlook for interest rates in the US remains relatively stable at least for the balance of the year, then monetary conditions in Indonesia could remain stimulative until higher inflation and/or the steadily deteriorating trend in the trade and current account balances becomes more entrenched and reflected in the currency risk premium.

The Impact of Portfolio Investment

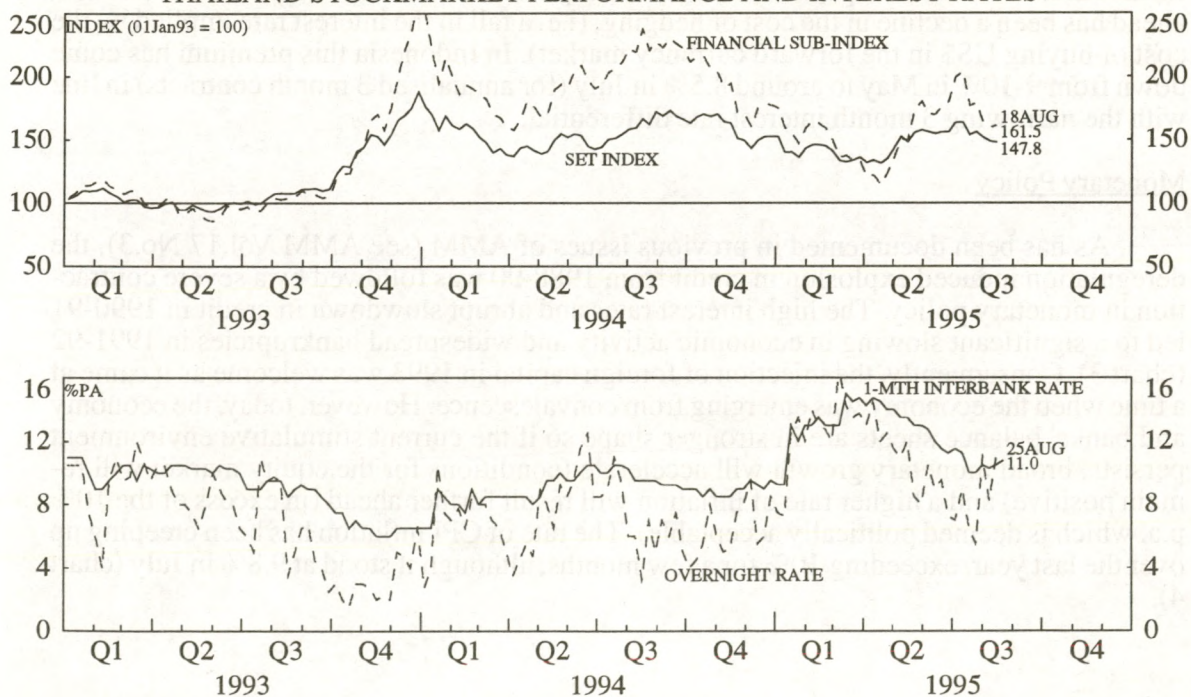
Since the early 1990s there has been a new phenomenon, growing in importance within East Asia, which qualitatively changes in the impact of the balance of payments on monetary policy. This concerns the growth in size and mobility of portfolio capital flows. This is possibly a result of increasing financial liberalisation within East Asia (and indeed in emerging markets in general), but equally, a consequence of the financial disintermediation in the US and in parts of Europe (i.e. a generalised switch from savings held as fixed deposits to funds with an international mandate). Against this background and given the predominance of exchange rate regimes which tie the local currency to the US\$, it is not suprising to see that capital flows are playing a bigger role in affecting domestic economic activity, in response to financial conditions in the US.

By contrast to the 1980s, as more investors take a closer look at the monetary policy regimes in place, (monetary) authorities are increasingly less able to disguise policy inconsistencies which may have persisted in the past. In economies such as Indonesia (and Thai-

INDONESIA: CHART 1
STOCKMARKET PERFORMANCE AND INTEREST RATES



INDONESIA: CHART 2
THAILAND STOCKMARKET PERFORMANCE AND INTEREST RATES



land), the recent upward pressure on their currencies from the strong influx of capital and the associated monetary impetus (if sustained) will at some time in the future generate more rapid inflation and tend to worsen their trade positions (if they adhere to their existing exchange rate policies and relatively open capital accounts).

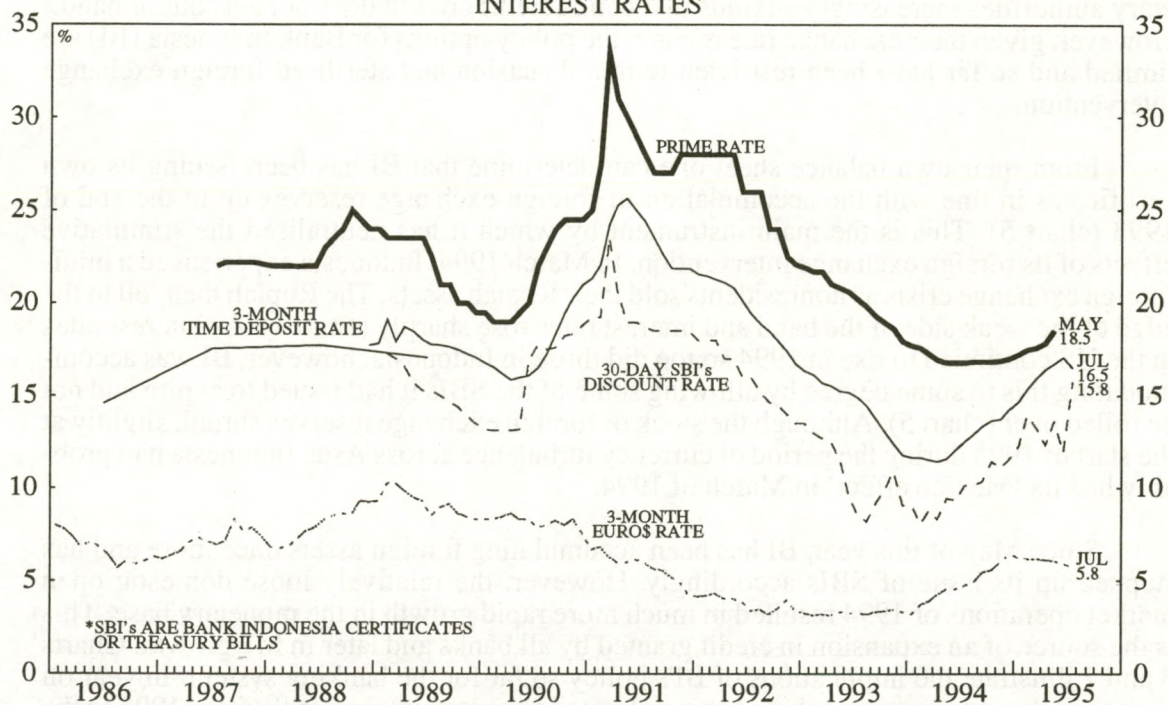
Charts 1 and 2 illustrate the impact which these major capital flows have had on local equity markets and interest rates over the last couple of years in Indonesia and Thailand. The impact of two waves of foreign investment are observable where in both cases the central banks found that the value of their currencies vis-a-vis the US\$ rose to an upper limit such that they were required to supply additional local currency to 'cap' the currency strength. In the first instance in 1993, the local stockmarket rally was preceded and accompanied by declining short term interest rates. However, this came to an abrupt halt at the start of 1994 as interest rates in the US rose, although later on in the year equity markets resumed their upward move. At the end of 1994, the impact of the withdrawal of funds from Mexico and the delayed effect of higher US interest rates gave rise to a minor and short lived Asian currency crisis in January (see AMM Vol. 19 No.1). The resulting tighter liquidity conditions (higher local rates of interest) laid the ground for a more sustained decline in equity prices.

However, since May of this year there has been a replay (so far on a smaller scale) of the events in 1993. As before, in Indonesia, the Rupiah/US\$ has moved to the strong side of its band in line with the higher nonresident demand for commercial paper, certificates of deposit (cds), other fixed deposits and equities. The overnight and shorter term fixed deposit rates have declined as Bank Indonesia has conducted sterilised foreign exchange intervention to 'cap' its currency and keep it within its officially guided range. Again, as before, banks and finance related stocks have outperformed other counters on the local stockmarket as they are the first to benefit from this environment of easier liquidity. A further indicator of the expectation that these capital inflows will continue in the months ahead has been a decline in the cost of hedging, (i.e. a fall in the interest rate implied by the cost of buying US\$ in the forward currency market). In Indonesia this premium has come down from 9-10% in May to around 8.5% in July (for annualised 3 month contracts) in line with the narrowing 3 month interest rate differential.

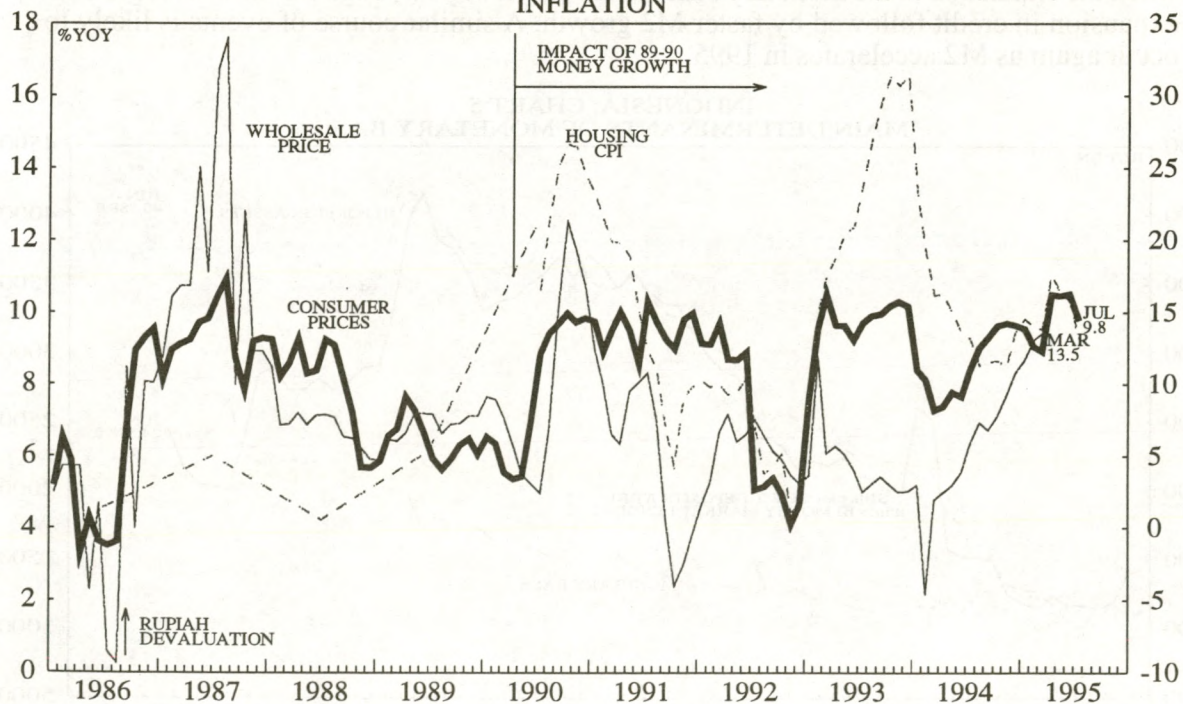
Monetary Policy

As has been documented in previous issues of AMM (see AMM Vol.17 No.3), the deregulation induced explosion in credit from 1988-90 was followed by a severe contraction in monetary policy. The high interest rates and abrupt slowdown in credit in 1990-91 led to a significant slowing in economic activity and widespread bankruptcies in 1991-92 (chart 3). Consequently, the injection of foreign capital in 1993 was welcome as it came at a time when the economy was emerging from convalescence. However, today, the economy and banks' balance sheets are in stronger shape so if the current stimulative environment persists, broad monetary growth will accelerate (conditions for the equity market will remain positive) and a higher rate of inflation will result further ahead (in excess of the 10% p.a. which is deemed politically acceptable). The rate of CPI inflation has been creeping up over the last year, exceeding 10% for a few months, although it stood at 9.8% in July (chart 4).

INDONESIA: CHART 3
INTEREST RATES



INDONESIA: CHART 4
INFLATION

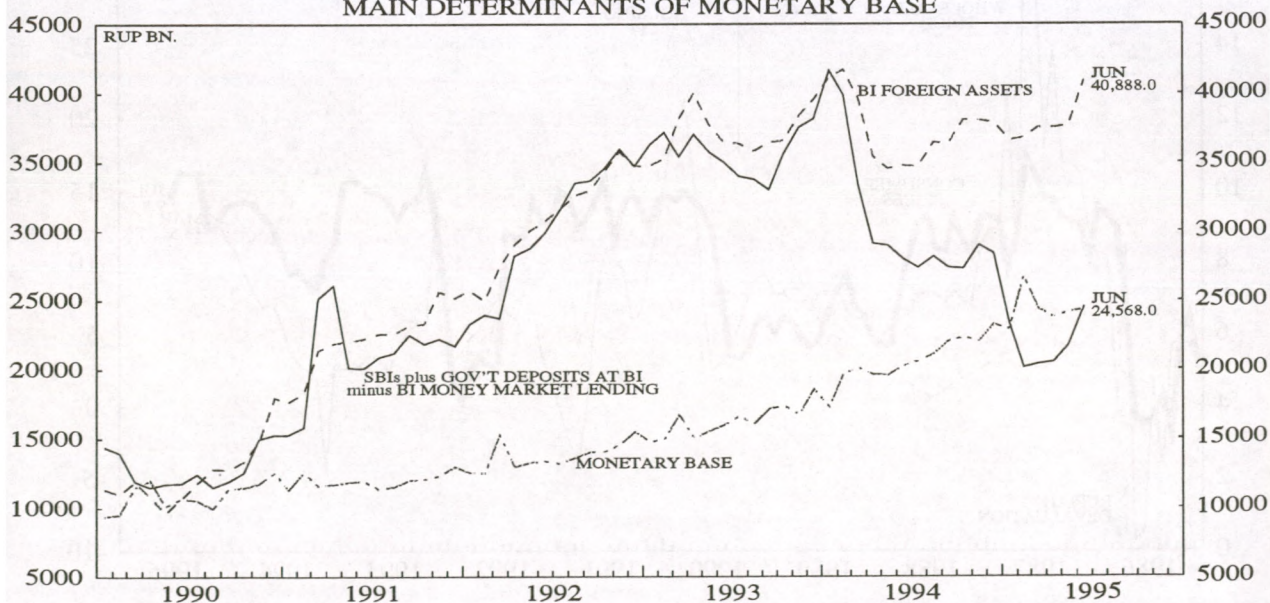


The trend in inflation coupled with the strength of the economy has made the monetary authorities increasingly anxious that banks credit growth does not get 'out of hand.' However, given their exchange rate regime, the policy options for Bank Indonesia (BI) are limited and so far have been restricted to moral suasion and sterilised foreign exchange intervention.

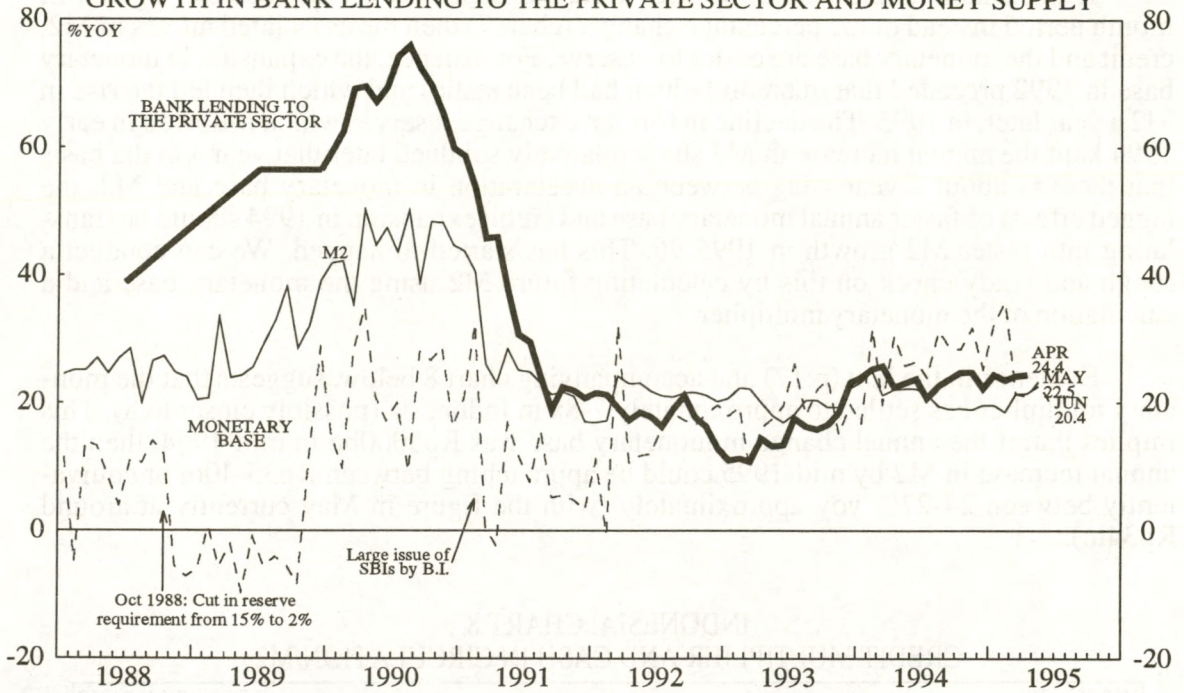
From their own balance sheet one can determine that BI has been issuing its own certificates in line with the accumulation of foreign exchange reserves up to the end of 1993 (chart 5). This is the main instrument by which it has neutralised the stimulative effects of its foreign exchange intervention. In March 1994, Indonesia experienced a mini-foreign exchange crisis as nonresidents sold their Rupiah assets. The Rupiah then fell to the edge of the weak side of the band and interest rates rose sharply (chart 1). As interest rates in the US continued to rise in 1994 so too did those in Indonesia, however, BI was accommodating this to some degree by allowing some of the SBIs it had issued to expire and not be rolled over (chart 5). Although the stock of foreign exchange reserves shrunk slightly at the start of 1995 during the period of currency turbulence across Asia, Indonesia had probably had its 'Mexico effect' in March of 1994.

Since May of this year, BI has been accumulating foreign assets once more and has stepped up its issue of SBIs accordingly. However, the relatively loose domestic open market operations of 1994 resulted in much more rapid growth in the monetary base. This is the source of an expansion in credit granted by all banks and later in M2 growth. Charts 6 and 7 illustrate the implications of BI's policy so far for the banking system. In year on year growth terms, monetary base has accelerated almost uninterruptedly from 1991 to the present day. However, bank credit growth (measured on this basis) reached a trough towards the end of 1992 and then started a new, albeit more subdued, upswing while the cycle in M2 has been even more subdued. From this it appears that 1993 was the key year when the expansion in the monetary base (in the previous year) began to feed through to an expansion in credit followed by faster M2 growth. A similar course of events is likely to occur again as M2 accelerates in 1995.

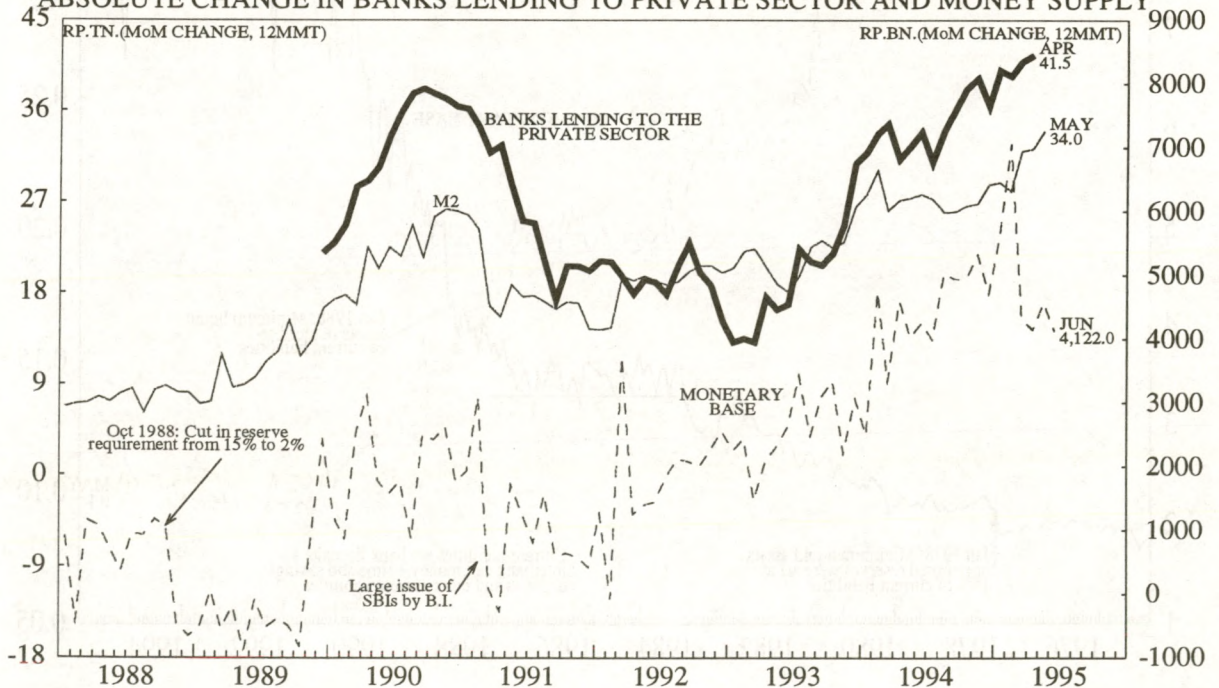
INDONESIA: CHART 5
MAIN DETERMINANTS OF MONETARY BASE



INDONESIA: CHART 6
GROWTH IN BANK LENDING TO THE PRIVATE SECTOR AND MONEY SUPPLY



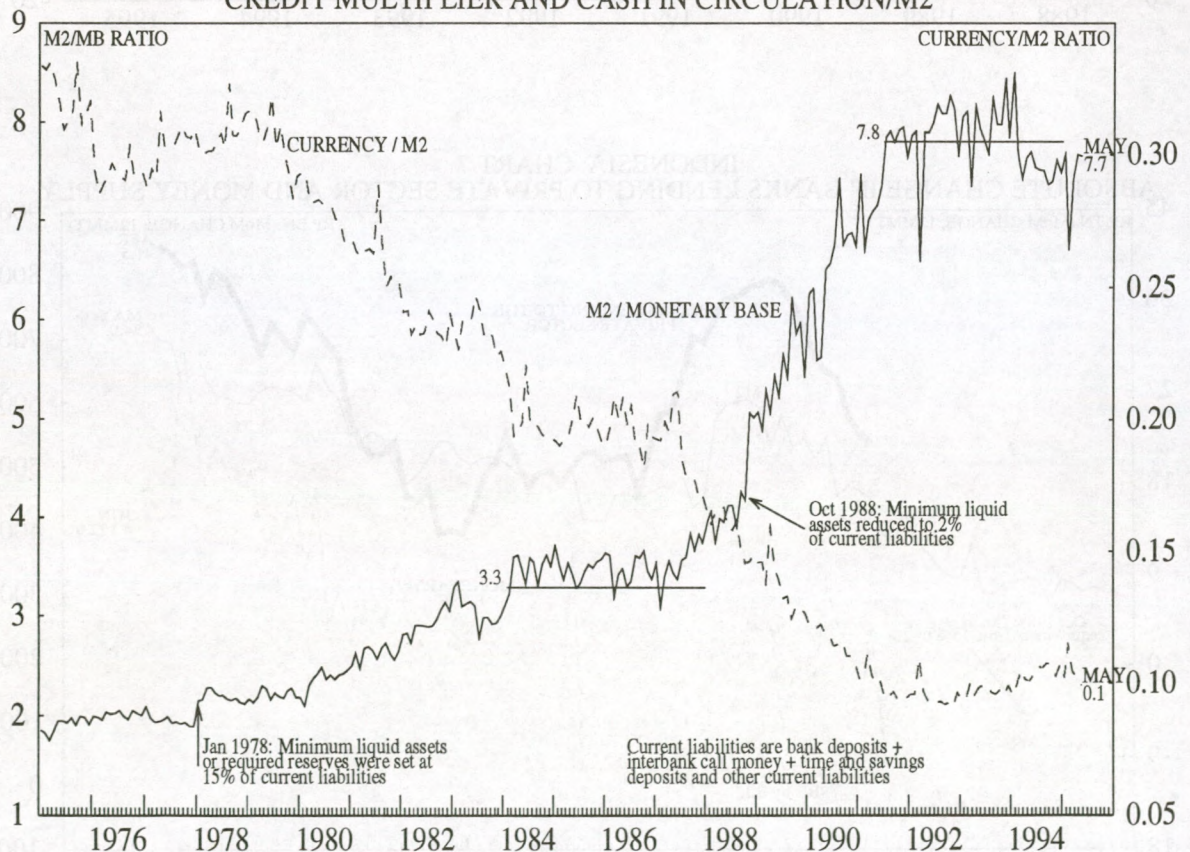
INDONESIA: CHART 7
ABSOLUTE CHANGE IN BANKS LENDING TO PRIVATE SECTOR AND MONEY SUPPLY



If one examines the absolute change in Rupiah deposits over the course of a given 12 month period instead of the percentage change, (chart 7) then the associated moves of M2, credit and the monetary base are easier to observe. For instance, the expansion in monetary base in 1992 preceded that in credit (which had been static) and which then led the rise in M2 a year later, in 1993. The decline in foreign exchange reserves which followed in early 1994 kept the annual increase in M2 stock relatively subdued later that year. On the basis that there is about a year's lag between an acceleration in monetary base and M2, the lagged effects of faster annual monetary base and credit expansion in 1994 should be translating into faster M2 growth in 1995-96. This has started to happen. We can conduct a rough and ready check on this by calculating future M2 using the monetary base and a calculation of the monetary multiplier.

Evidence in the box (p.17) and accompanying chart 8 below, suggests that the monetary multiplier has settled to approximately 7-8x in Indonesia (possibly closer to 8). This implies that if the annual change in monetary base was Rp5000bn in mid-1994, then the annual increase in M2 by mid-1995 could be approaching between Rp35-40tn or equivalently between 24-27% yoy approximately (with the figure in May currently at around Rp34tn).

INDONESIA: CHART 8
CREDIT MULTIPLIER AND CASH IN CIRCULATION/M2



The Monetary Multiplier

In a fractional reserve banking system a monetary multiplier can be computed which essentially defines the ratio between the level of a broad monetary aggregate (in this case M2) and the level in the monetary base. It can vary according to a number of factors: in Indonesia the main two which have influenced the multiplier over the last 15-20 years are the ratio of currency in circulation to M2 and reserve requirements. This relation can be shown simply as the following equation:

$$M2/\text{Monetary base} = (1 + r) / (c + r)$$

where r is the reserve requirement and c is the ratio of currency in circulation to M2. In more advanced economies the multiplier is affected by the extent of disintermediation in the banking system. For instance the growth of non-bank private sector assets held in non-bank financial intermediaries or in the form of equity mutual funds generates an additional layer of deposit creation. With changes in interest rates there can be substantial portfolio shifts of non-bank private sector assets across the bank and non-bank sectors (affecting M2 without impacting the monetary base).

As can be seen from chart 8, in Indonesia (as in other Asian economies) there has been a continuous decline in currency in circulation as a percentage of M2 although it appears to have stabilised (and risen slightly) since 1992. This secular trend has been one contributor to the rise in the monetary multiplier. The other factor is the decline in reserve requirements. They had been set at 15% of current liabilities at the start of 1978 and were reduced to 2% in October 1988. Using the formula above, in the mid 1980s the multiplier was around 3.3 ($= 1.15/0.35$), but after such a drastic relaxation in reserve requirements in 1988 (accounting for the change in the reserve ratio) the multiplier rose to around 7.8 ($= 1.02/0.13$). The movement in chart 8 of the monetary multiplier conforms to these calculations.

One would expect this new multiplier to remain reasonably stable provided that the cash and reserve ratios remain relatively stable and that there is no sudden disintermediation of the banking system lurking round the corner.

As can be seen from chart 7, there is a seasonal element to the monetary base, making it spike upwards every January/February (depending when Chinese New Year falls). Abstracting from this there appears to have been some slowing in the annual change in the monetary base in the second quarter of 1995 which suggests that BI has temporarily succeeded in (oversterilising) the capital inflows at this time. This carries the obvious implication that a year from now M2 will slow (to between Rp29-33tn or 16-18% yoy). How temporary this would be depends on the growth of the monetary base in the meantime and whether BI choose at some point to change the cost of intermediation within the banking system.

If the upward pressure on the Rp/US\$ persists then faced with the prospect of accelerating M2 (and the increased likelihood of greater systemic risk from banks increased exposure to property lending), BI is increasingly likely to take action, although it would be unlikely to involve (a) BI introducing additional capital controls on Rupiah assets held by nonresidents, or (b) a break in the current exchange rate regime. In the first instance, the band of fluctuation around the Rupiah could be widened further, introducing additional volatility/uncertainty into prospective short term capital inflows. BI have periodically been doing this over a number of years, most recently on the 30th June where the band of fluctuation was raised from +/-0.7% to +/-1% either side of the central daily fix. A second course of action (unfriendly to equities) would be raising or broadening the 2% reserve requirement which has been in place since October 1988.⁽¹⁾

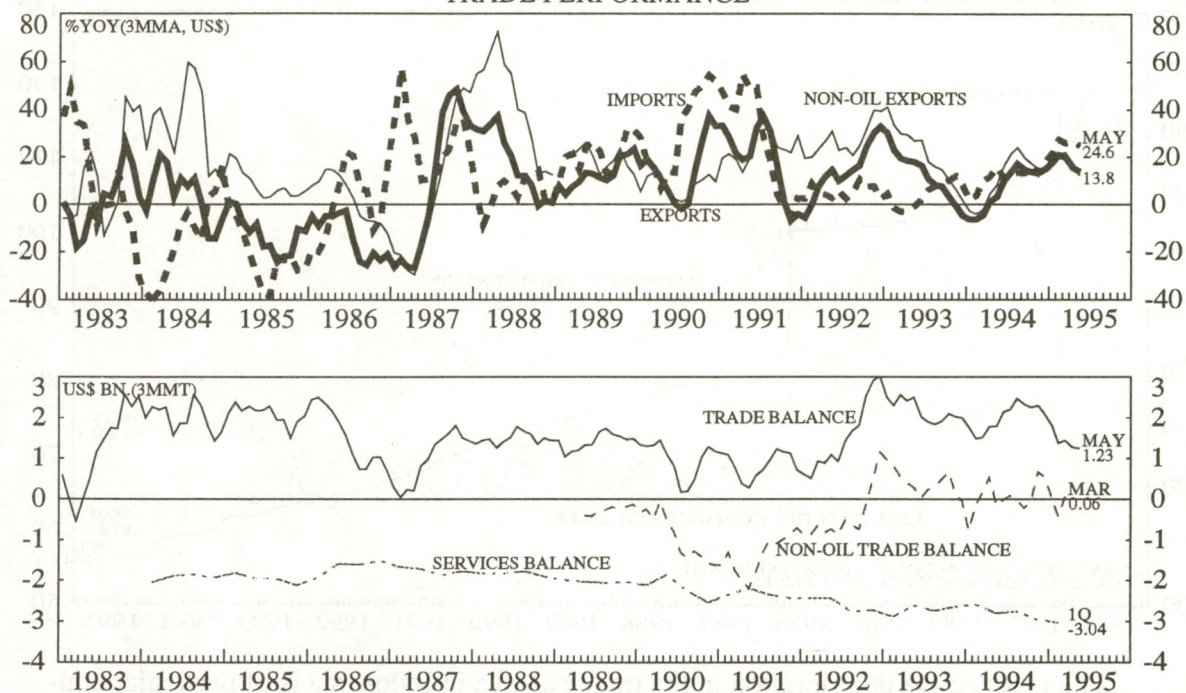
In the final section of this article, we examine the current account and expectations of its future direction. This forms an important check on currency expectations and on the implications for domestic monetary conditions given the nature of the exchange rate regime.

The Current Account

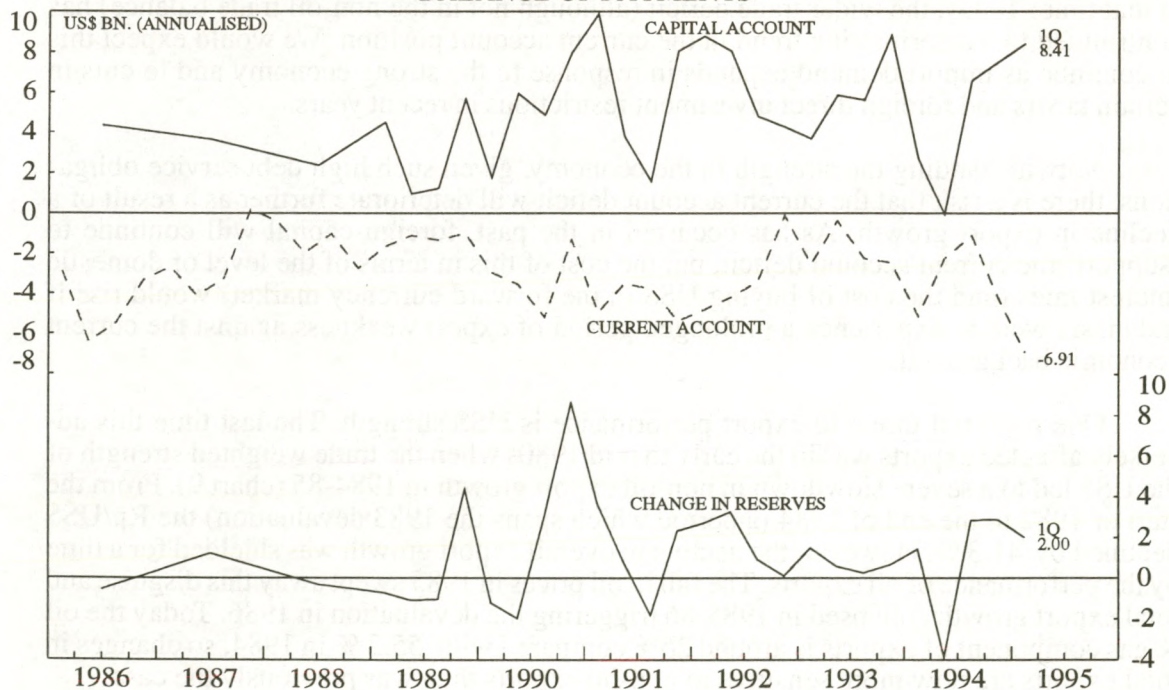
Like many of the other ASEAN economies, Indonesia experienced a deterioration in its trade and current account balances during the overheating years of 1990-91. By 1993, through a combination of strong non-oil export growth and more subdued non-oil import growth, the trade position staged an impressive recovery (charts 9 and 10). However, from 1993 onwards the tables appear to be turning again although so far the non-oil balance has remained stable. As the economy has gathered steam so too has import demand and if, as we expect, economic growth remains robust then the trade balance (in total and non-oil terms) looks increasingly likely to deteriorate in the year ahead.

(1) One potential longer term problem of imposing higher reserve requirements is that if the change is dramatic enough and if the central bank pays penal (below market interest rates) on these reserves, then there is an incentive for banks to evade them and a process of disintermediation takes place.

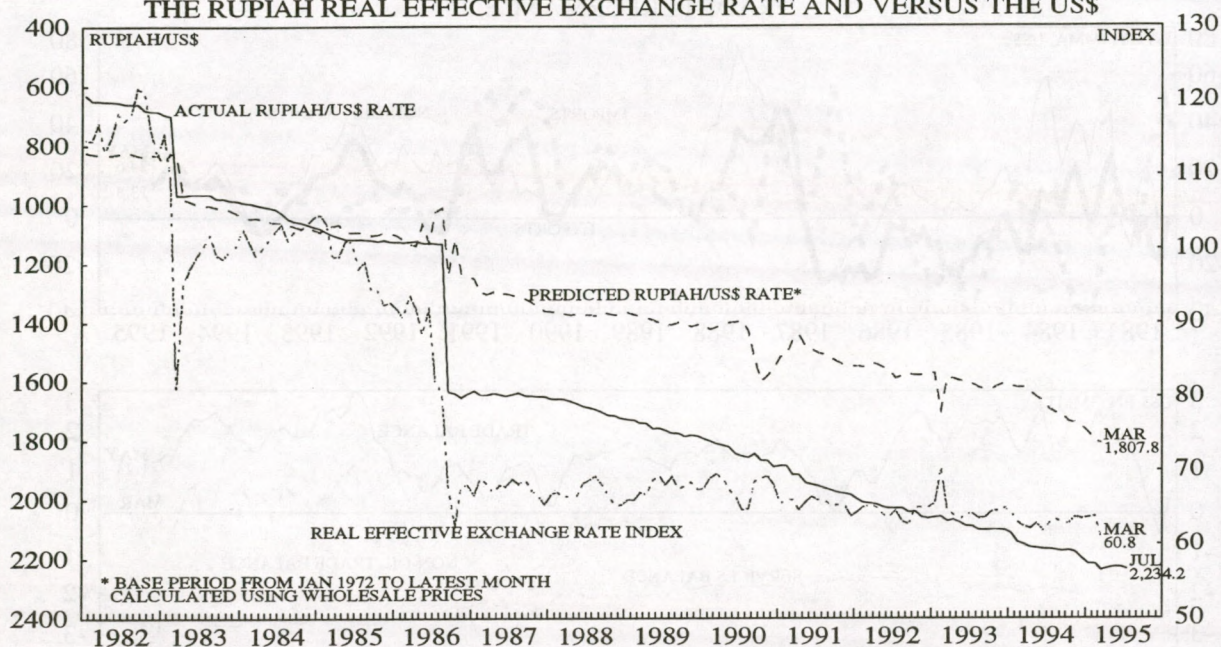
INDONESIA: CHART 9
TRADE PERFORMANCE



INDONESIA: CHART 10
BALANCE OF PAYMENTS



INDONESIA: CHART 11
THE RUPIAH REAL EFFECTIVE EXCHANGE RATE AND VERSUS THE US\$



The prospective deterioration in the trade balance in Indonesia is of particular concern because of the large external debt servicing component that burdens the economy year in-year out. In 1993 its total external debt stock was around US\$89.5bn, of which 77% was publicly guaranteed. Interest payments of US\$3.7bn representing 11.3% of total exports of goods and services had to be made and this contributed to the minor current account deficit at that time. Today, the wider trade deficit (although not in the non-oil trade balance) has contributed to a deteriorating trend in the current account position. We would expect this to continue as import demand expands in response to the strong economy and to cuts in certain tariffs and foreign direct investment restrictions in recent years.

Notwithstanding the strength in the economy, given such high debt service obligations, there is a risk that the current account deficit will deteriorate further as a result of a decline in export growth. As has occurred in the past, foreign capital will continue to 'support' the current account deficit, but the cost of this in terms of the level of domestic interest rates (and the cost of buying US\$ in the forward currency market) would rise if Indonesia were to experience a prolonged period of export weakness against the current economic background.

One potential threat to export performance is US\$ strength. The last time this adversely affected exports was in the early to mid 1980s when the trade weighted strength of the US\$ led to a severe slowdown in non-oil export growth in 1984-85 (chart 9). From the start of 1982 to the end of 1984 (a period which spans the 1983 devaluation) the Rp/US\$ declined by 41.3 %. However, the decline in overall export growth was shielded for a time by the performance of oil exports. The fall in oil prices in 1985 swept away this disguise and total export growth collapsed in 1985-86 triggering the devaluation in 1986. Today the oil & gas component of exports is around 25% compared with 55.2 % in 1984, so changes in total exports are now more sensitive to non-oil exports than was previously the case.

Given that the US\$ is unlikely to mimic the strength it had in the early 1980s the risk of slower export growth on this basis over the next couple of years is low. In addition the lags between significant rises in the US\$ and dampened export growth are long (up to 2 years). Chart 11 shows two common measures of competitiveness in bilateral and trade weighted terms. In bilateral terms, purchasing power parity (PPP) trends do not suggest that there has been much sustained change in the extent of undervaluation of the Rp/US\$, as shown. In real trade weighted terms, there has been a smooth increase in competitiveness since the start of 1990 by about 14%, however as with the PPP measure, no drastic change in valuation has occurred to affect export performance either way in the foreseeable future.

In sum, the risk of a significant slowing in export growth on the basis of recent exchange rate moves is relatively low, but nevertheless it appears likely that the trade and current accounts will deteriorate further this year on the basis that import growth will continue to accelerate. This will represent a growing withdrawal of liquidity from the banking system which can be completely overshadowed by the influx of foreign capital as is currently the case.

SUMMARY AND CONCLUSIONS: Although the current monetary upswing is a lot more subdued than the previous one it has been gathering steam since the end of 1992 and the economy has followed suit. With the more widespread acceptance of a subdued cycle in US interest rates in early 1995, foreign investors have returned to Indonesia and found value in the equity and money markets pushing up the value of the Rp/US\$ to the upper end of the target band. If the influx of foreign capital persists, there will be a further impetus delivered to monetary growth and downward pressure on interest rates will remain. This could lead to further action by BI to rein in the loosening credit conditions. One of the few avenues open to it, given the exchange rate regime, is to introduce 'regulatory grit' into the wheels of financial intermediation, by for instance, raising/broadening reserve requirements: an obvious negative point for the equity market.

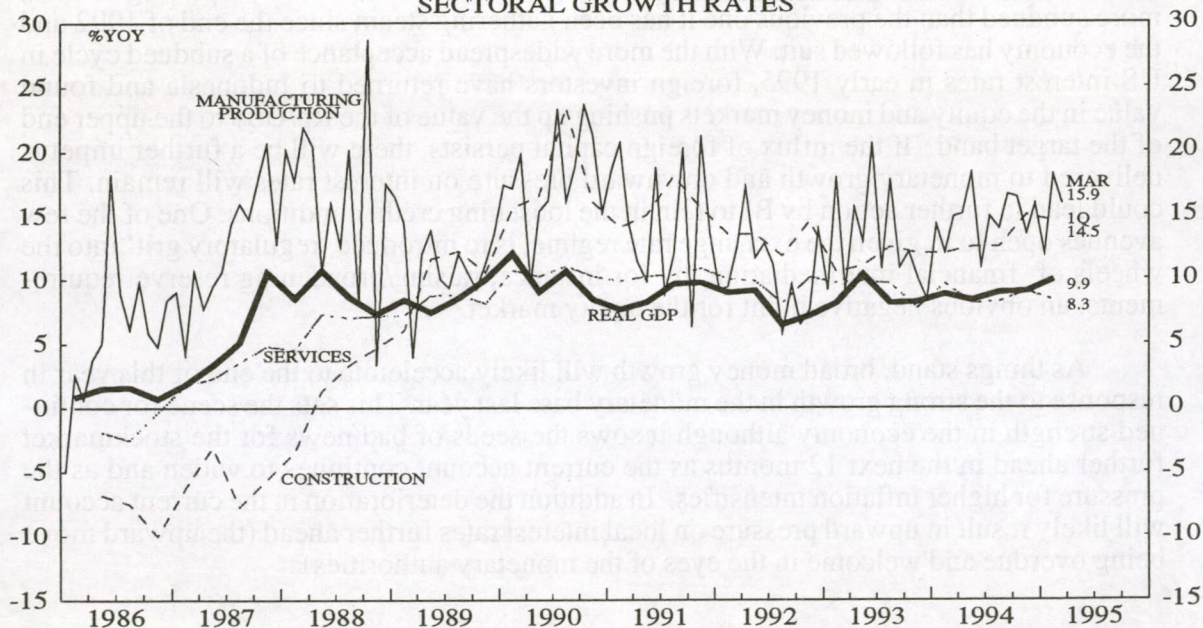
As things stand, broad money growth will likely accelerate to the end of this year in response to the strong growth in the monetary base last year. This sets the scene for continued strength in the economy although it sows the seeds of bad news for the stockmarket further ahead in the next 12 months as the current account continues to widen and as the pressure for higher inflation intensifies. In addition the deterioration in the current account will likely result in upward pressure on local interest rates further ahead (the upward move being overdue and welcome in the eyes of the monetary authorities).

MALAYSIA MONETARY ADJUSTMENT TO MODERATE GROWTH

Introduction

After growth of 8.7% in 1994, real output in Malaysia grew by an annualised 9.9% in 1995 Q1, the strongest quarterly performance since 1993Q2 (Chart 1). First quarter GDP data, coupled with strong manufacturing production numbers in the year so far, suggest that Malaysia will record another year of enviable growth for the eighth consecutive year. A sectoral breakdown of the 1995Q1 GDP data suggests that economic activity continues to be broadly based, with especially strong performances in the manufacturing (+15.2%), mining (+7.9%), construction (+14.5%), and services (+8.3%) sectors. On the demand side, export growth has picked up to around 21% YoY, but net exports are deteriorating reflecting the strength of domestic absorption. Against this buoyant backdrop, inflation has remained remarkably subdued, at 3.5%, with the Consumer Price Index taking brief respite from its broadly upward trend.

MALAYSIA: CHART 1
SECTORAL GROWTH RATES



This article accepts that CPI inflation will continue to rise in the coming months reflecting the strength of domestic demand and excess money supply. It argues however that the balance of payments may present a more immediate and pressing constraint for investors (as in 1991) unless meaningful steps are taken now to rein in domestic credit growth. To begin with we review monetary conditions, highlighting the extent of excess money supply, and the central bank's hesitation in tightening monetary conditions. Then using a monetary approach to the balance of payments we conclude that the stern action necessary to restrain credit growth is likely to be politically unacceptable, so that the adjustment will probably be slow and painful, taken largely through higher domestic prices. In the meantime, BNM's current benign neglect of the exchange rate is to be encouraged. If monetary equilibrium is successfully pursued, then growth will almost certainly moderate late in 1996 and 1997; not least as investment and domestic absorption slacken.

A Legacy of Excess Liquidity

Malaysia has over many years accumulated a legacy of easy money, bequeathed to it by the "cheap ringgit" policy of the 1980s. This policy, aimed at preserving the attractiveness of Malaysia as an investment location, operated primarily through undervaluation of the currency and domestic assets. Exchange rate targeting compelled the central bank to accumulate foreign exchange reserves and supply Ringgit liquidity. More recently however, in 1992-93, the central bank attempted to check interest pressures that emerged as a consequence of capital inflows. These attempts to simultaneously target both the exchange rate and interest rates became increasingly untenable as upward pressures on the real exchange rate began to mount. In 1992-93, the growing inconsistency between monetary policy and domestic fundamentals was exploited spectacularly by currency speculators anticipating a two-way gain from nominal currency appreciation and high interest rates. The resultant monetary overhang from this episode is now well documented (AMM, Vol 18, No.4).

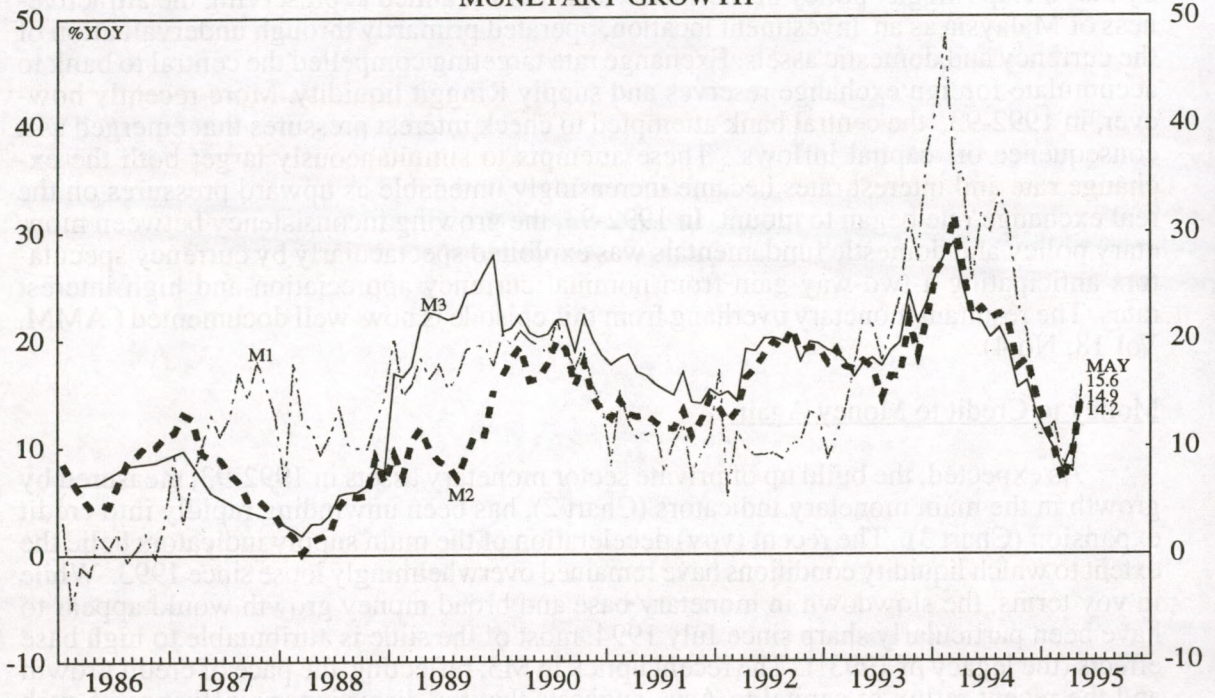
Money to Credit to Money Again

As expected, the build up of private sector monetary assets in 1992-93, measured by growth in the main monetary indicators (Chart 2), has been unwinding rapidly into credit expansion (Chart 3). The recent (yoy) deceleration of the main supply indicators belie the extent to which liquidity conditions have remained overwhelmingly loose since 1993. While in yoy terms, the slowdown in monetary base and broad money growth would appear to have been particularly sharp since July 1994, most of the slide is attributable to high base effects (the legacy of 1993!). The recent uptick in M3, reflecting the pace of credit growth and the recent reflux of capital to Asia, suggests that the distortionary influence of such base effects is waning. More worrying is the implication that monetary conditions are becoming more stimulative once again.

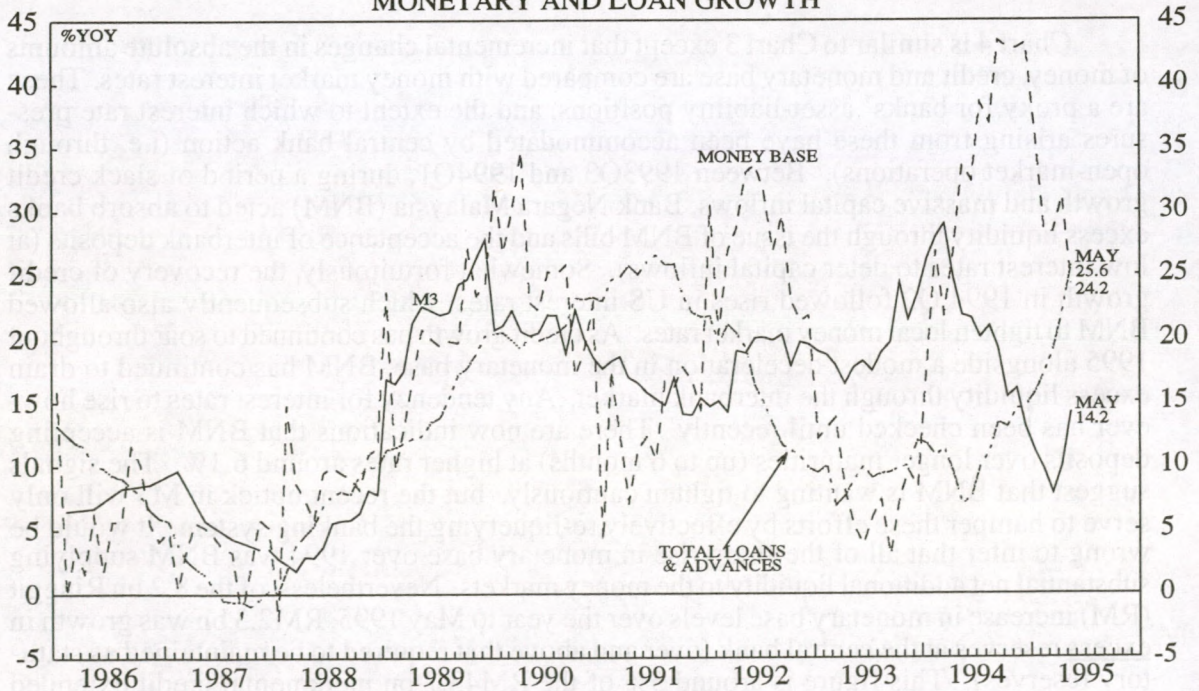
Central Bank Tightening Cautiously

Chart 4 is similar to Chart 3 except that incremental changes in the absolute amounts of money, credit and monetary base are compared with money market interest rates. These are a proxy for banks' asset-liability positions, and the extent to which interest rate pressures arising from these have been accommodated by central bank action (i.e. through open-market operations). Between 1993Q3 and 1994Q1, during a period of slack credit growth and massive capital inflows, Bank Negara Malaysia (BNM) acted to absorb banks excess liquidity through the issue of BNM bills and the acceptance of interbank deposits (at low interest rates to deter capital inflows). Somewhat fortuitously, the recovery of credit growth in 1994 Q2 followed rises in US interest rates, which subsequently also allowed BNM to tighten local money market rates. As credit growth has continued to soar throughout 1995 alongside a modest deceleration in the monetary base, BNM has continued to drain excess liquidity through the interbank market. Any tendency for interest rates to rise however has been checked until recently. There are now indications that BNM is accepting deposits over longer maturities (up to 6 months) at higher rates around 6.1%. The signals suggest that BNM is wanting to tighten cautiously, but the recent uptick in M3 will only serve to hamper these efforts by effectively re-liquefying the banking system. It would be wrong to infer that all of the sharp rise in monetary base over 1994 was BNM supplying substantial net additional liquidity to the money markets. Nevertheless, of the 8.2 bn Ringgit (RM) increase in monetary base levels over the year to May 1995, RM2.3 bn was growth in excess reserves at the central bank (over and above that required to be maintained as statutory reserves). This figure is around 5% of the RM43.7 bn incremental credit extended during the same period. On this figuring, BNM is continuing to accommodate credit expansion at relatively low interest rates.

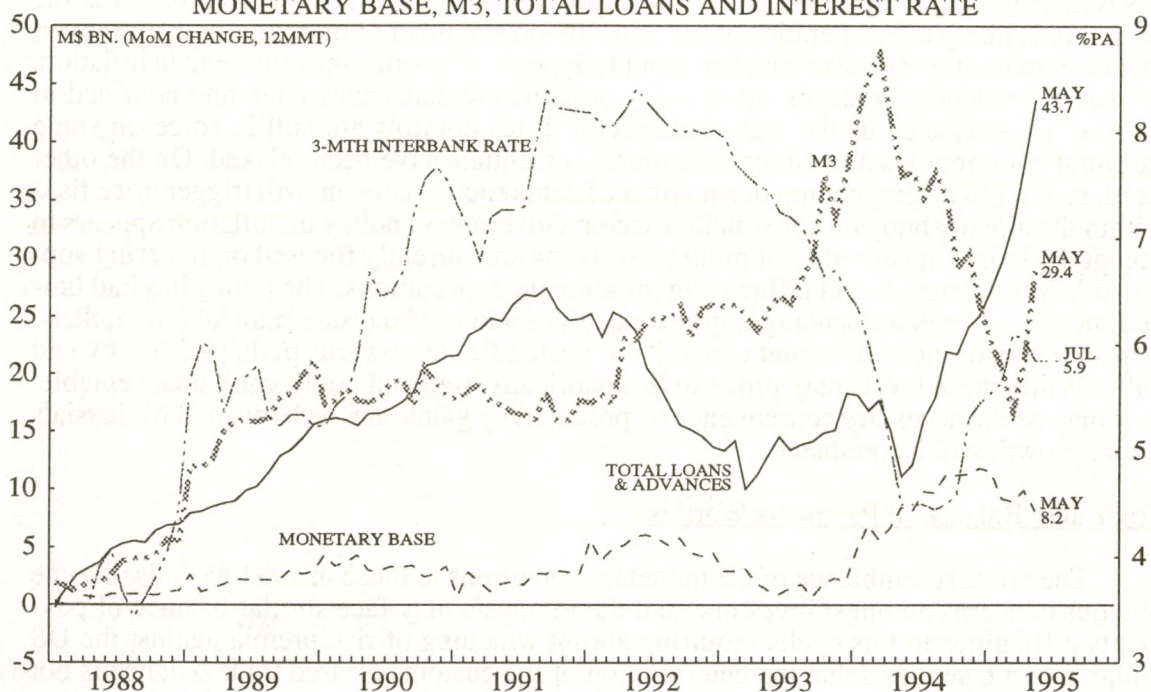
MALAYSIA: CHART 2
MONETARY GROWTH



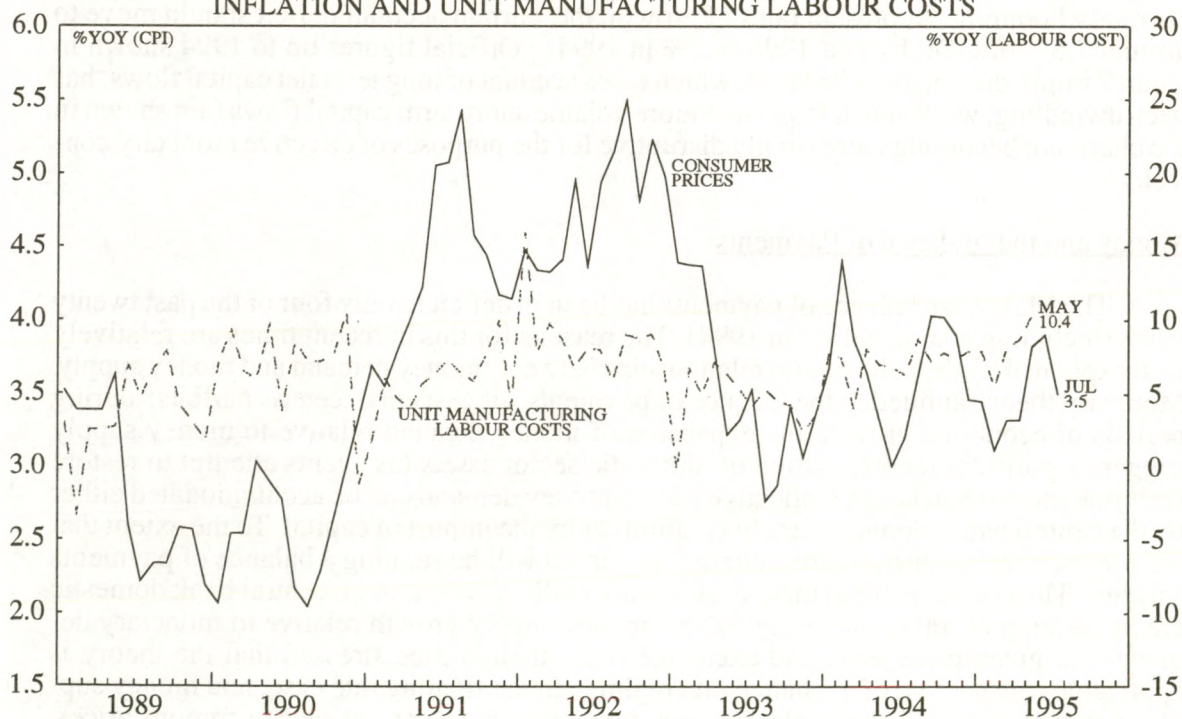
MALAYSIA: CHART 3
MONETARY AND LOAN GROWTH



MALAYSIA: CHART 4
MONETARY BASE, M3, TOTAL LOANS AND INTEREST RATE



MALAYSIA: CHART 5
INFLATION AND UNIT MANUFACTURING LABOUR COSTS



Inflation Remains Subdued

Despite the sharp boost to liquidity over the past two years, CPI Inflation (Chart 5) has remained surprisingly benign. We have previously shown (see Vol 18 No.4) that the economy is likely to be operating at full capacity on a number of measures and, moreover, that the unwinding of excess liquidity should support the broadly upward trend in inflation. However, evidence for strong inflationary pressures remains anecdotal, and confined to narrow pockets such as the real estate sector. Price controls are still in force on some essential commodities and duties on imported essentials have been relaxed. On the other hand, recent price deregulation of a number of items such as cement will trigger price rises within the already buoyant construction sector. Government policy on inflation appears to accept the long-run neutrality of money, so efforts are currently focused on fostering supply-side improvements and influencing inflationary expectations. The policy has had limited success so far in influencing wage expectations within Malaysia's tight labour markets. Capacity constraints will mount generally to push inflation towards perhaps 5.5% by end 1996. While these levels may prove to be historically high and politically unacceptable, they may be the necessary consequence of productivity gains on which much of Malaysia's future growth will be predicated.

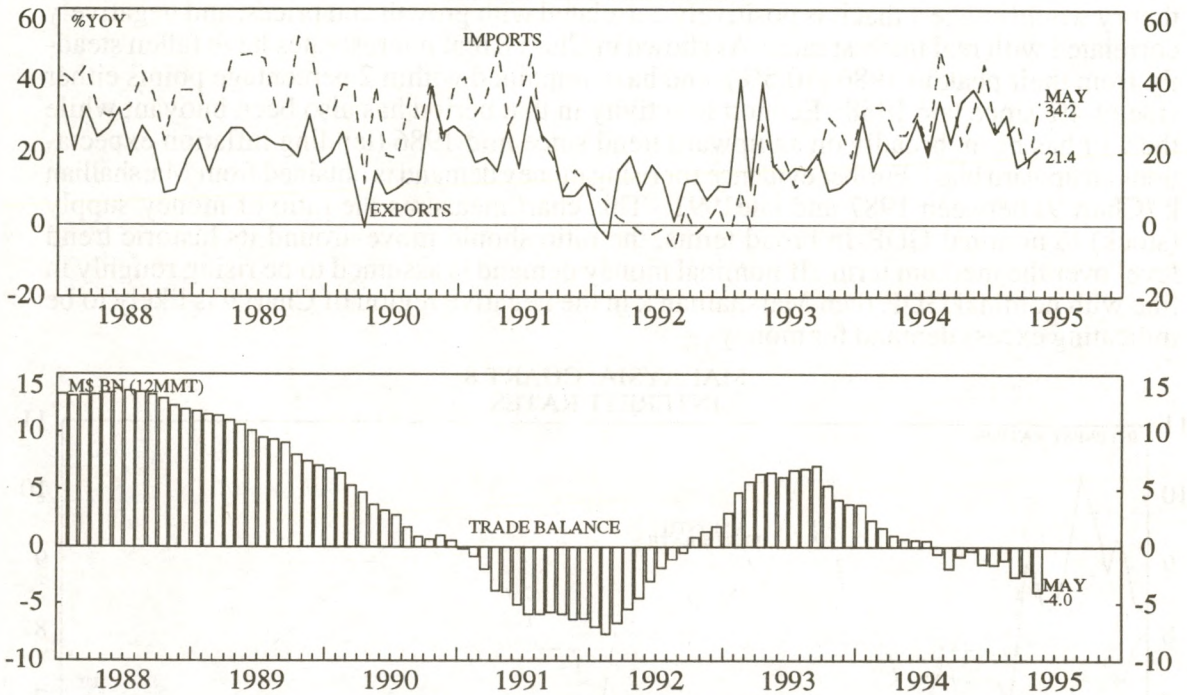
Trade and Balance of Payments Worries

The crude resemblance of the monetary conditions to those in 1991 has raised some obvious concerns amongst investors that the Malaysia may face similar balance of payments difficulties in this cycle; requiring abrupt widening of risk premia against the US dollar. Chart 6 suggests that the deterioration of the customs cleared trade balance is not yet as rapid as in 1991, although BNM will be sensitive to currency markets' growing intolerance towards external imbalances. Strength of the semi-conductor cycle and growth in intra-Asia trade will support future export performance. Infrastructure investments however will continue to suck in high value capital items while sales of imported cars are currently booming. At present rates of growth, the current account deficit should move to around 7.5% of GDP by end-1995 (6.3% in 1994). Official figures up to 1994 shown in Chart 7 imply that the basic balance, which takes account of long term net capital flows, has been dwindling, while much larger and more volatile short-term capital flows (not shown in the chart) are becoming increasingly disruptive for the purposes of effective monetary control.

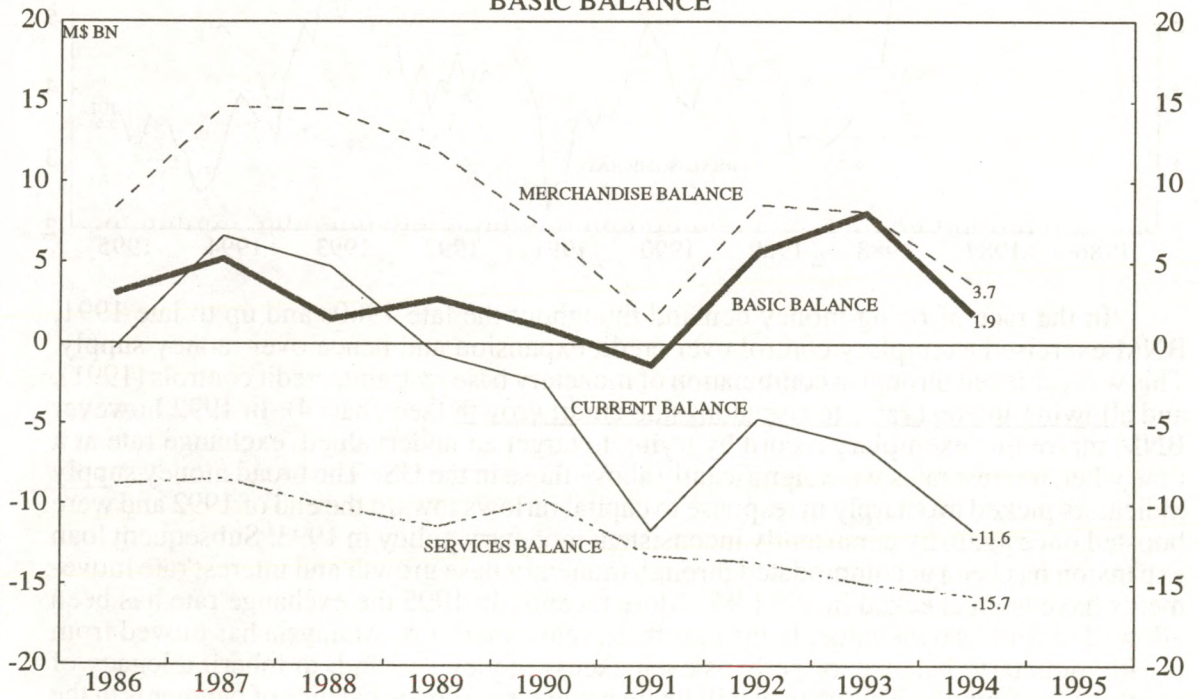
Money and the Balance of Payments

The Malaysian balance of payments has been in deficit in only four of the past twenty years (including a large deficit in 1994). The reasons for this in recent times are relatively well explained by the behavioural relationships between money demand and money supply. Monetary theory applied to the balance of payments suggests that, *ceteris paribus*, during periods of economic growth, the expansion of money demand relative to money supply triggers a portfolio recomposition of domestic sector assets (as agents attempt to restore their real money balances). Collective excess money demand can be accommodated either by the central bank (domestic credit creation) or by the import of capital. To the extent that the former is not occurring, the country concerned will be running a balance of payments surplus. Thus balance of payments deficits are really a symptom of central bank domestic credit creation or, more generally, excess money supply growth relative to monetary demand at a given price level and exchange rate. It should be stressed that the theory is applicable irrespective of exchange rate regime. In the floating rate case, real money supply is determined endogenously because domestic prices are not tied to foreign prices. Monetary expansion by the authorities under floating exchange rates leads to downward pressure on the nominal exchange rate, and upward pressure on the domestic price level.

MALAYSIA: CHART 6
TRADE PERFORMANCE

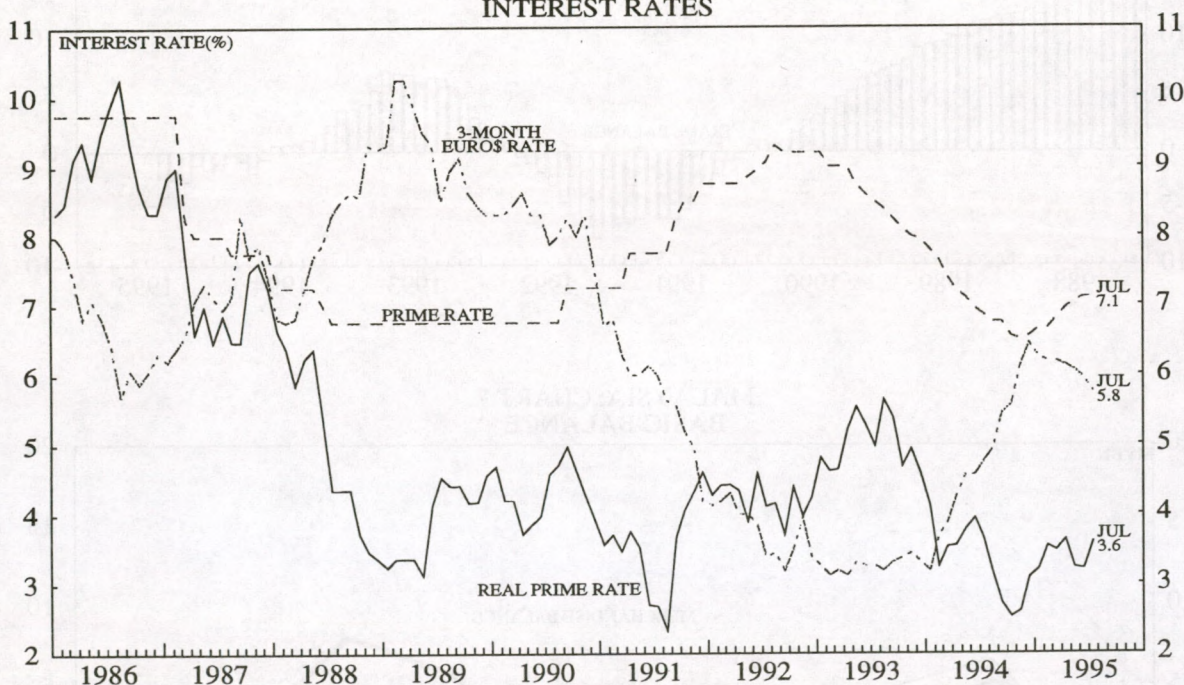


MALAYSIA: CHART 7
BASIC BALANCE



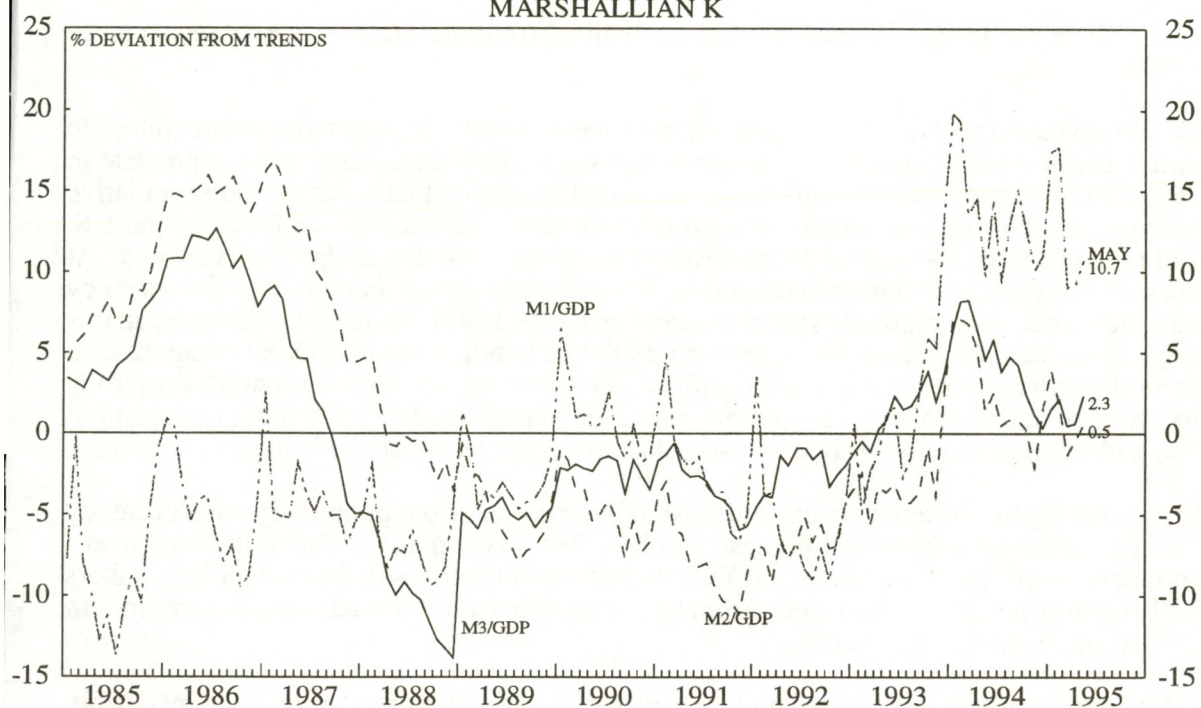
Is the theory borne out by the Malaysian experience? Arguably it has over the past eight years since 1986. Money demand is very difficult to observe in practice although theory would suggest that it is positively correlated with growth and prices, and negatively correlated with real interest rates. As shown in Chart 8 real interest rates have fallen steadily from their peak in 1986 (10.5%) and have remained within 2 percentage points either side of 4% since late 1988. Economic activity in that period has also been buoyant while the CPI has been broadly on an upward trend since mid 1986 (lending inflation expectations an upward bias). Further evidence for rising money demand is obtained from Marshallian k (Chart 9) between 1987 and late 1991. This chart measures the ratio of money supply (stock) to nominal GDP. In broad terms, the ratio should move around its historic trend level over the medium term. If nominal money demand is assumed to be rising roughly in line with nominal GDP, then Marshallian k in the negative region of Chart 9 is likely to be indicating excess demand for money.

MALAYSIA: CHART 8
INTEREST RATES

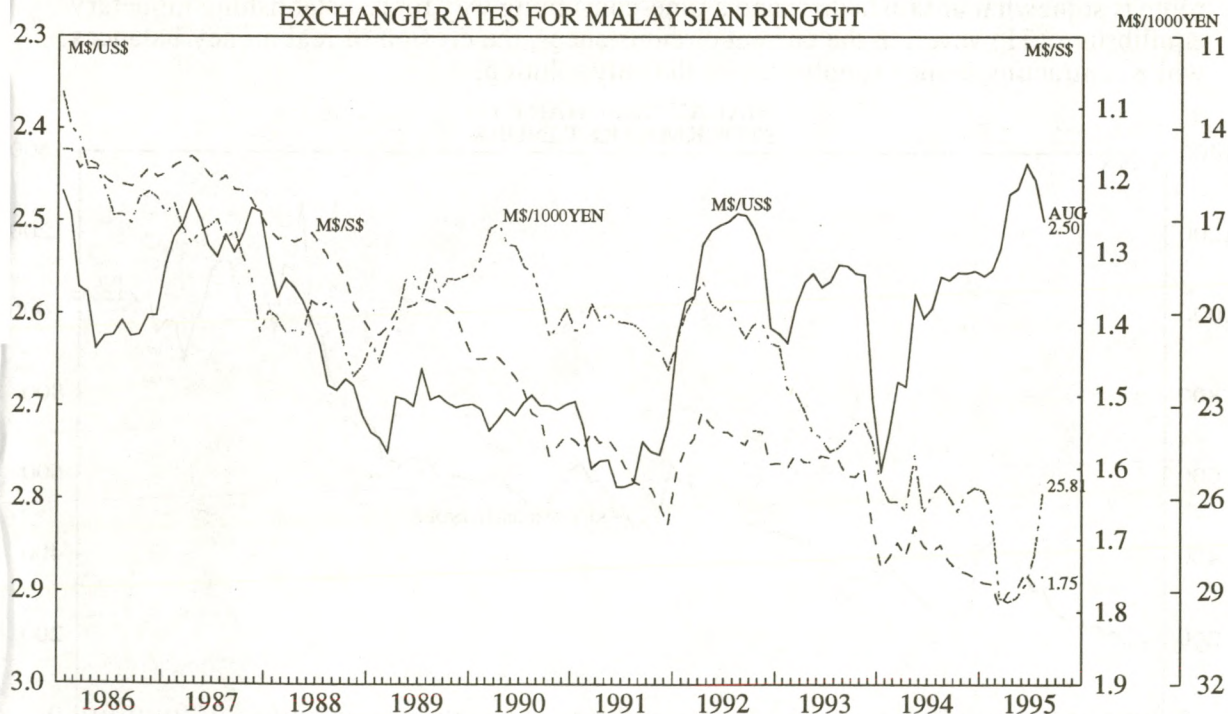


In the face of rising money demand throughout the late 1980s and up to late 1991, BNM exercised exemplary control over credit expansion and hence over money supply. This was achieved through a combination of monetary base restraint, credit controls (1991), and allowing interest rates to rise alongside credit growth (see chart 4). In 1992 however BNM marred its exemplary record by trying to target an undervalued exchange rate at a time when interest rates were significantly above those in the US. The broad money supply indicators picked up sharply in response to capital inflows toward the end of 1992 and were boosted once again by persistently inconsistent monetary policy in 1993. Subsequent loan expansion has been accommodated through monetary base growth and interest rate movements have been checked in 1994-95. More recently in 1995 the exchange rate has been allowed to find its own value. In the past three years, therefore, Malaysia has moved from broad monetary balance, or perhaps even excess money demand, to inherit a legacy of excess money supply. This change will likely put pressure on the balance of payments in the short-term. An appropriate mix between exchange rates and interest rates needs to be found while pulling in the reins on loan growth at the same time.

MALAYSIA: CHART 9
MARSHALLIAN K



MALAYSIA: CHART 10
EXCHANGE RATES FOR MALAYSIAN RINGGIT



The Policy Options

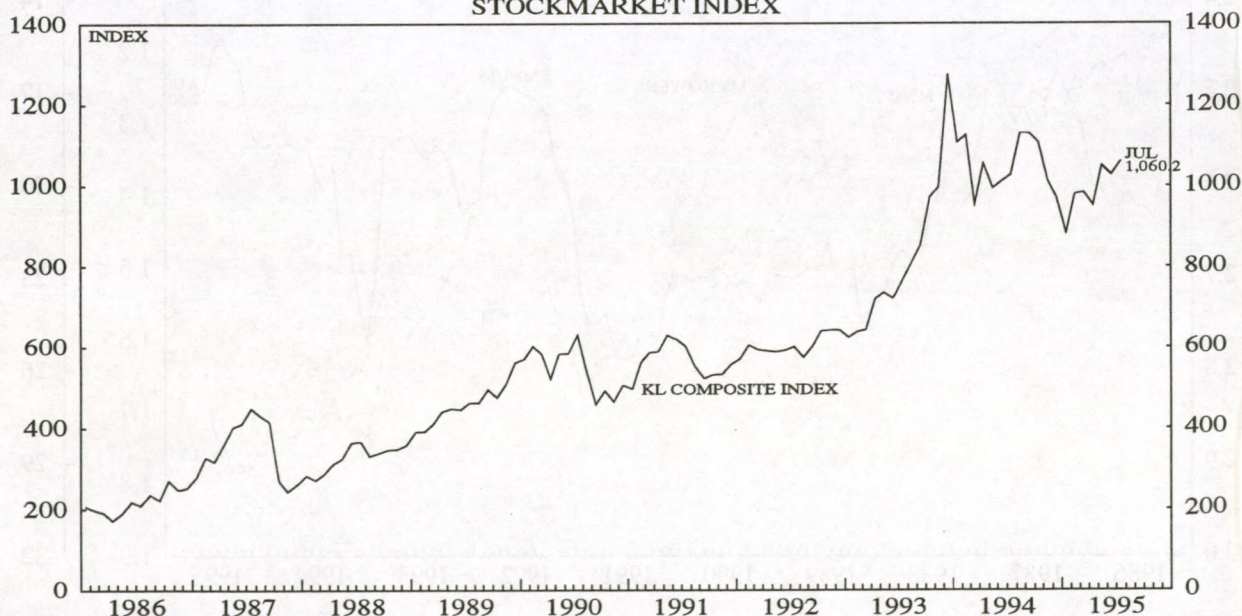
There are several lessons that can be distilled from the Malaysian experience since 1992:

(1) While the pursuit of simultaneous interest rate and exchange rate targets is not possible under any monetary regime, the exchange rate should have been allowed to appreciate in 1992, in response to capital inflows. This would have eventually dampened speculative activity, while at the same time allowed interest rates to remain above levels in the US. Both interest rates and exchange rates would then have served to deflate the economy. At present, Ringgit depreciation is reflecting US dollar strength (Chart 10) and the currency has, therefore, been relatively steady in effective terms. BNM should not be deterred at this stage from raising interest rates, as long as the currency is then allowed to appreciate naturally in response to any capital inflow. Over the longer term, assuming no policy inconsistencies or monetary accommodation, the natural tendency for money demand to rise with economic activity should ensure that upward pressure on the Ringgit is sustained.

(2) Insulating the current account and especially exporters from potentially wide currency swings during the adjustment process will be politically sensitive. The dollar's recovery should be helpful in this respect (the Yen's weakness much less so) although policy makers will probably need to intervene occasionally to ensure that currency adjustments are smooth and, to some extent, anticipated.

(3) As excess money supply unwinds into inflation and a growing current account deficit, the more painful process of monetary adjustment through prices and a slowdown in real domestic demand must now be allowed to operate. From a balance of payments perspective, interest rates will have to rise further to stem loan and money supply growth. This route is somewhat unsatisfactory and a time-consuming way for re-establishing monetary equilibrium. However, in the current circumstances, the erosion of real money balances while contracting money supply may be the only solution.

MALAYSIA: CHART 11
STOCKMARKET INDEX

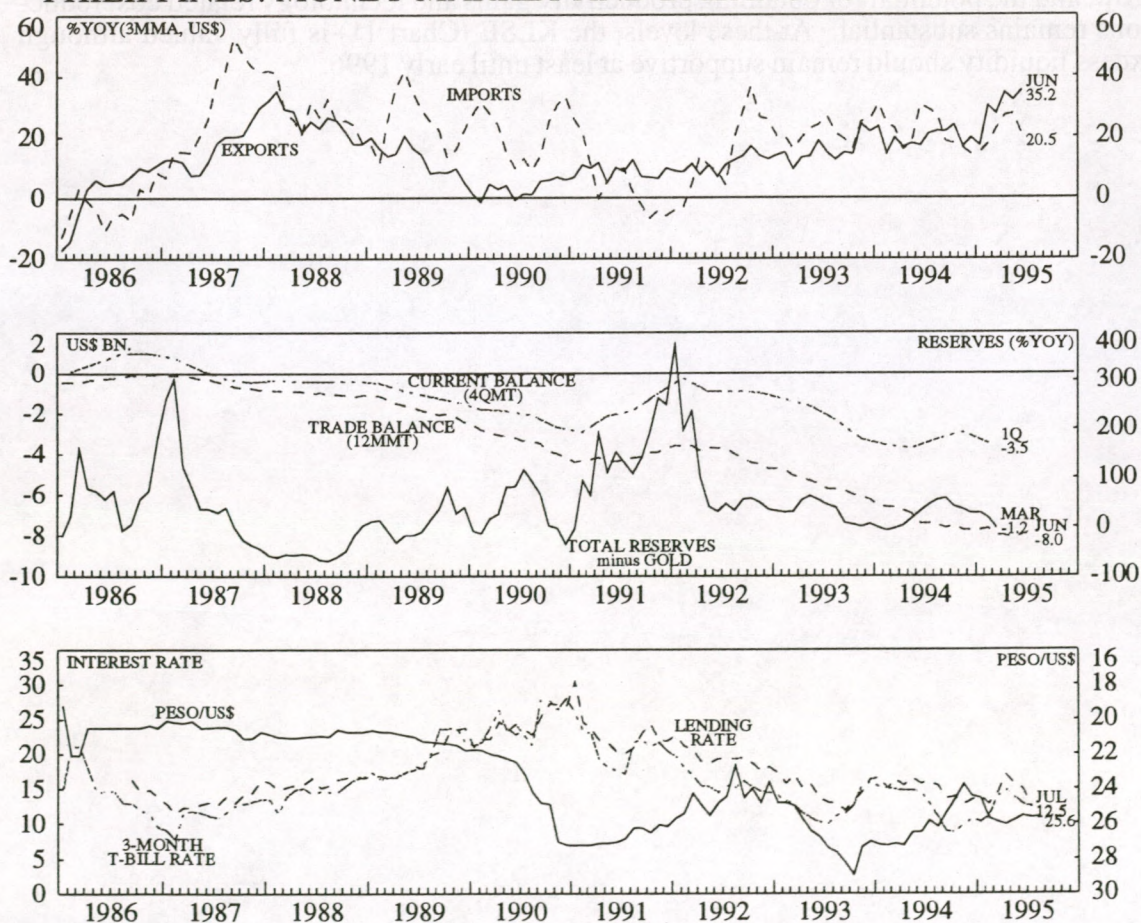


SUMMARY AND FORECASTS: We have shown in this article that Malaysia continues to suffer from the effects of excess monetary growth during 1992 and 1993. The main worry at this stage is an apparent reluctance to tighten monetary conditions further (pre-emptively) in the face of strong domestic demand. Dampening credit growth will be essential if balance of payments funding is to stay manageable alongside a deteriorating current account deficit. Our perception is that BNM appreciates the interest rate and exchange rate inconsistencies generated in 1992 and is consequently shifting its focus to managing interest rates only. However, while interest rates will gradually rise over the coming year, credit will need to be reined in more forcefully if its contribution to money supply growth is to be controlled. The levels of nominal interest rates required to achieve this -- probably prime rates near 9% -- would be politically unacceptable and costly to the public purse. Thus Malaysia will probably be forced down the more difficult and painful route of increasing nominal money demand through inflation and/or imposing credit controls (implicit or explicit) as in 1991. Taken together, policy actions in 1995-96 and renewed Ringgit appreciation through 1996 should moderate real growth to around 8.0% by the end of 1996, while inflation may rise to around 5.5% in that time frame. The expected erosion of real money balances and subsequent private sector attempts to restore these, is likely to be broadly negative for the equity market over the coming year -- especially later in 1996. In the absence of significant, additional, productivity gains, earnings will be affected in the medium term by rising wage costs, except perhaps in the financial sector where margins will grow, and the potential for obtaining productivity gains and technology related cost reductions remains substantial. At these levels, the KLSE (Chart 11) is fully valued although excess liquidity should remain supportive at least until early 1996.

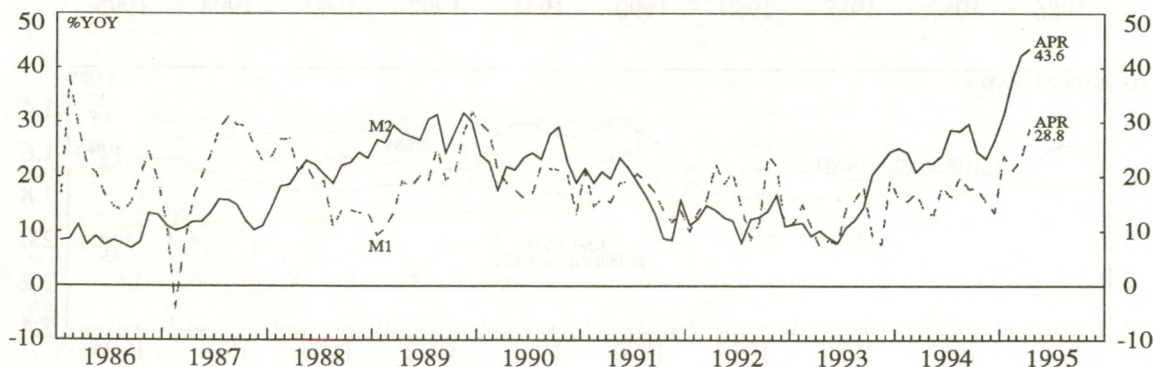
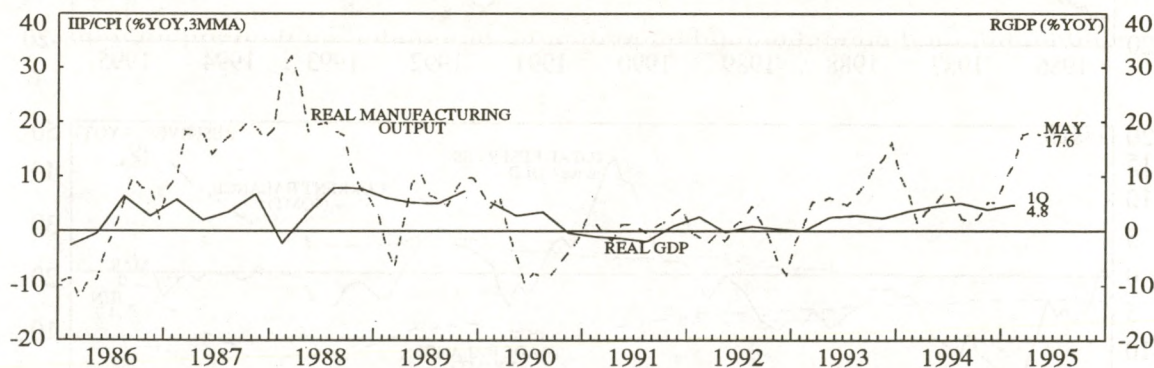
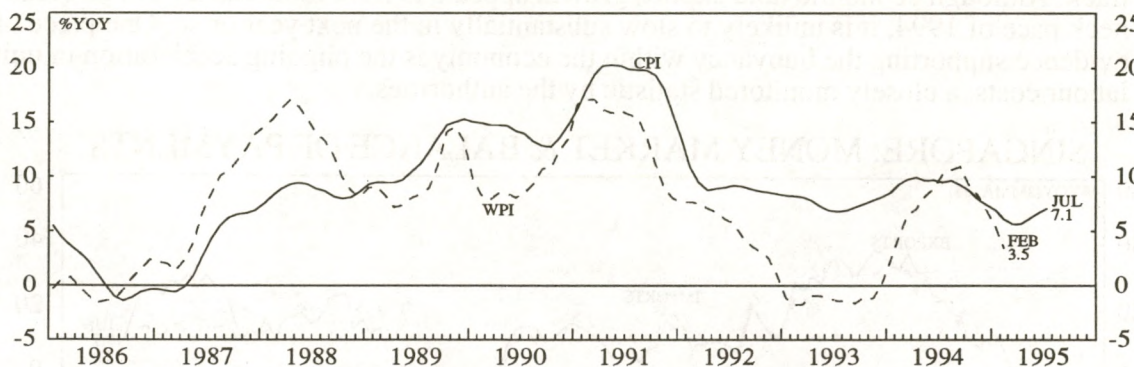
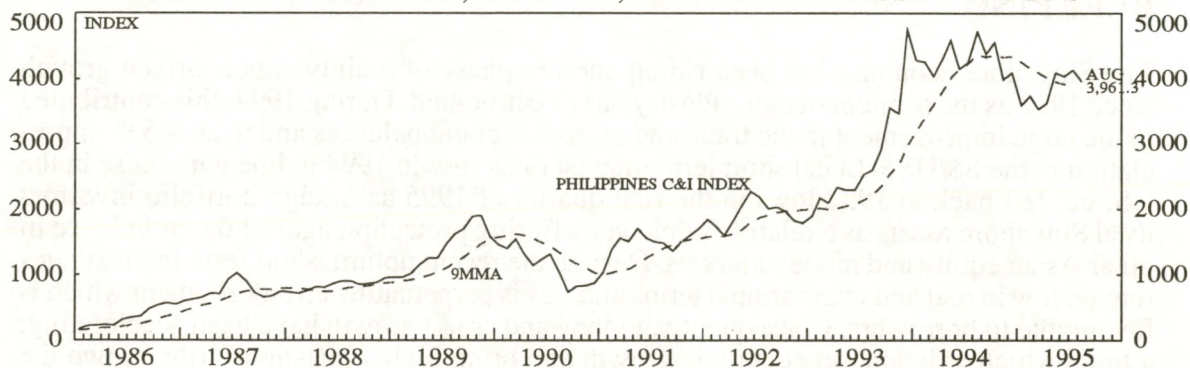
PHILIPPINES: SHORT-TERM BUOYANCY CARRIES LONG-TERM RISKS

Broad money growth (M2) is indicating that monetary conditions remain overwhelmingly loose. However, this would ignore the obvious pick-up in money demand (decreased velocity) associated with currently buoyant economic activity and financial deregulation. The anticipated boost to inflation is being mitigated at present by peso strength. Meanwhile, the bellwether 3-month T-Bill rate has eased substantially in the wake of ongoing capital inflows. IMF kudos of the Ramos reforms, and economic progress to date, was accompanied by a loosening of IMF program targets. The target for real growth remains unchanged at 6-6.5% for 1995 while the year-average inflation target is revised upwards from 6.5% to 7.5%. In essence, the country continues to enjoy a liquidity driven investment wave, that can be sustained as long as the balance of payments remains funded at prevailing interest rates and exchange rates. In this regard, export growth in 1995 so far has been spectacular although import growth remains equally robust. Recent statistical changes to Balance of Payments accounting will exacerbate a worsening trade picture. The medium-term risk for equities is that inflation will eventually precipitate a re-assessment of private sector asset portfolios (the "real balance" effect). In the current liquidity environment the immediate risks of such an abrupt adjustment are remote. Nevertheless, what inflation does not achieve, monetary tightening may.

PHILIPPINES: MONEY MARKET AND BALANCE OF PAYMENTS



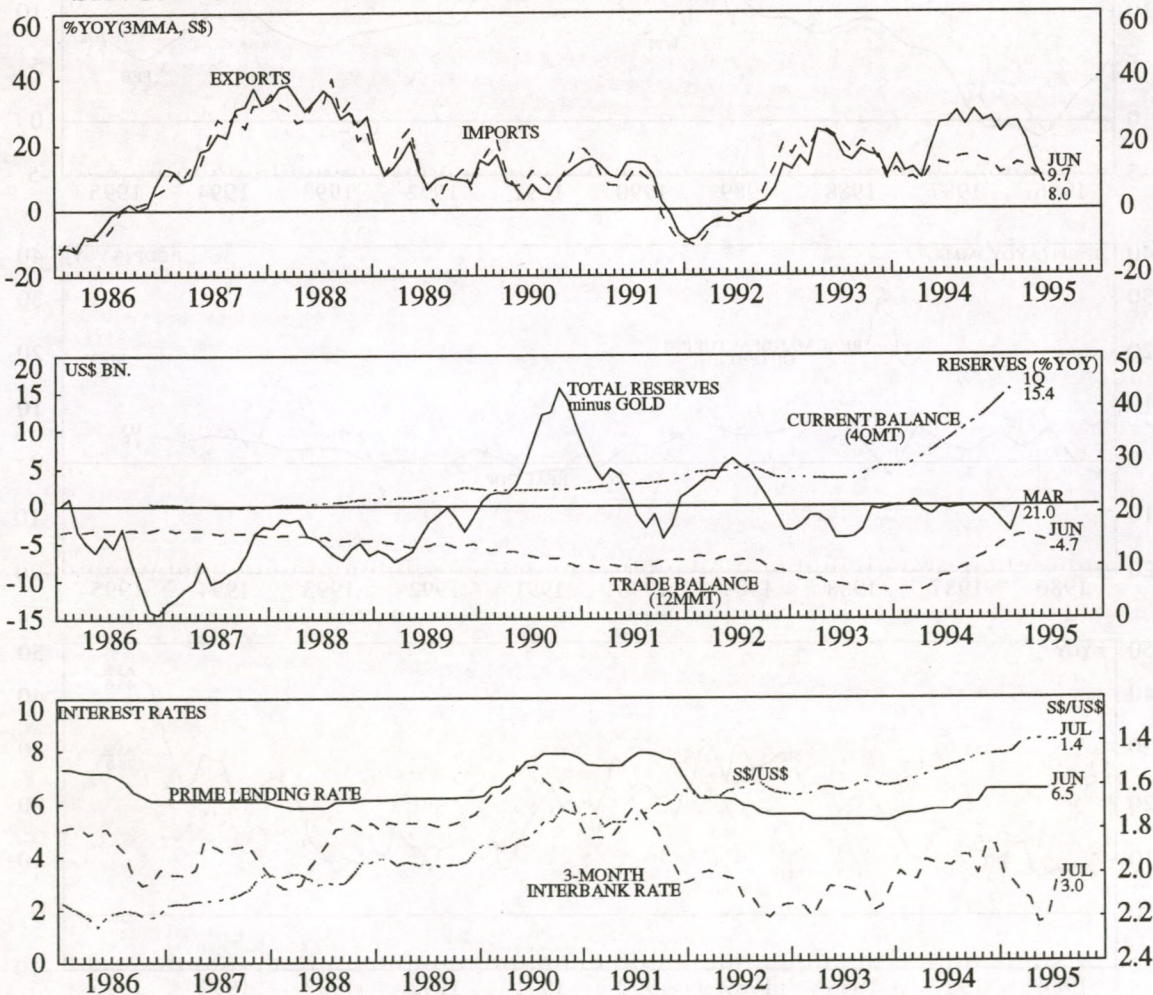
PHILIPPINES: MONEY, OUTPUT, GOODS AND ASSET PRICES



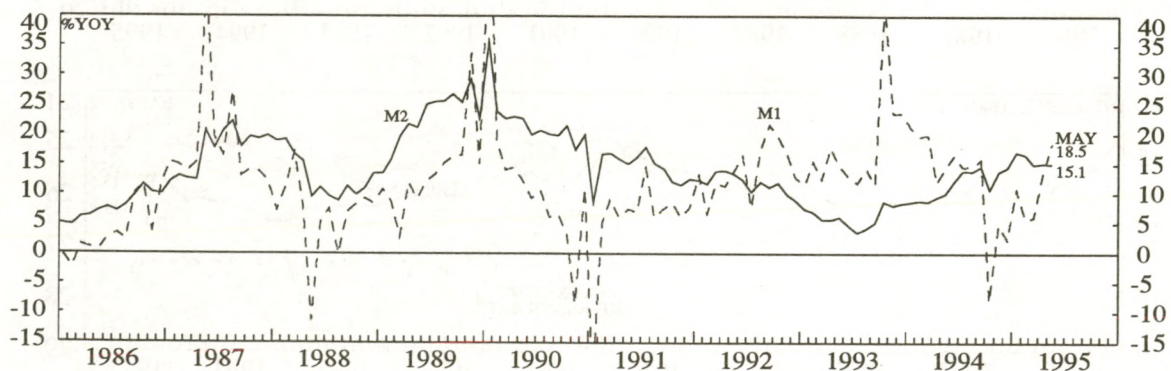
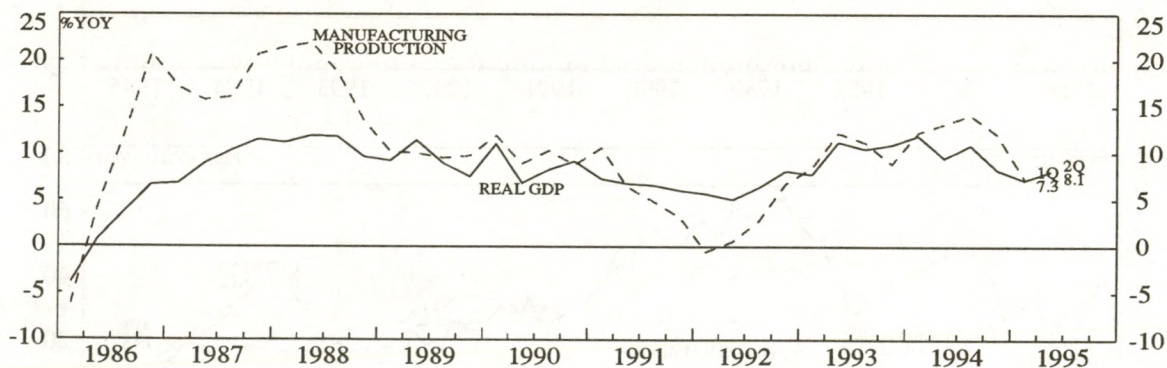
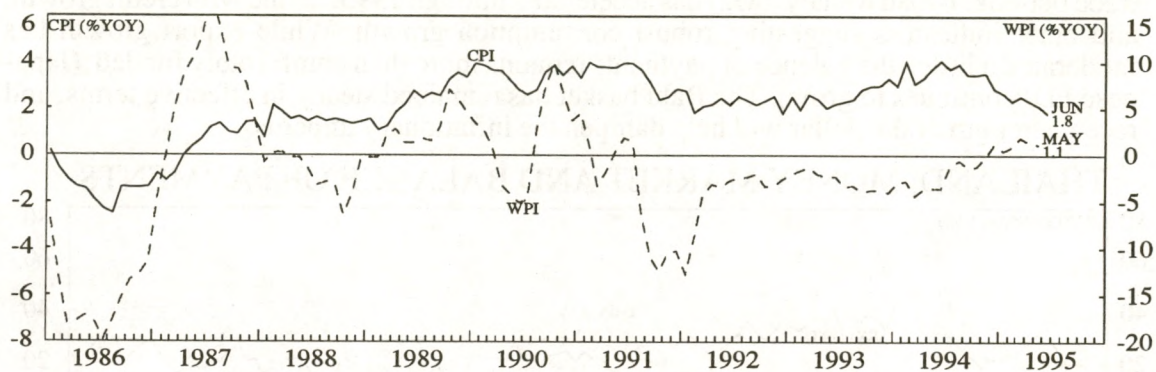
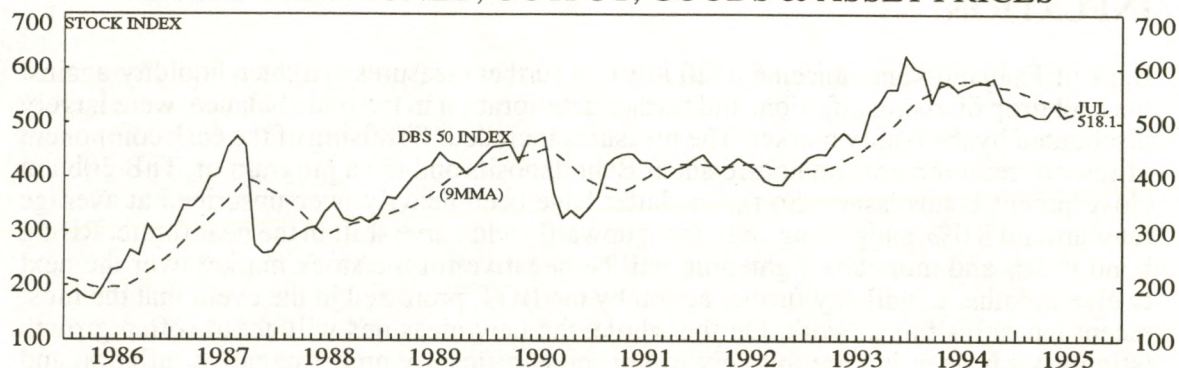
SINGAPORE: ECONOMIC SPEEDOMETER BUZZER STARTS BLEEPING

The Singapore economy has been riding another phase of mainly export driven growth since 1992 as the semiconductor industry has mushroomed. During 1994, this contributed to the large improvement in the trade and current account balances and to an 8.5 % appreciation in the S\$/US\$. Local short term interest rates rose in 1994 in line with those in the US, but fell back to 1992 lows in the first quarter of 1995 as foreign portfolio investors used Singapore assets as a relative safehaven offering protection against the turbulence in other Asian equity and money markets. Despite the recent upturn, short term interest rates remain low in real and international terms and this is perpetuating an environment which is favourable to borrowers. Consequently, money and credit growth have been accelerating: a trend which will support economic growth and bring higher inflation further down the track. Although economic (and export) growth appears to have moderated from its break-neck pace of 1994, it is unlikely to slow substantially in the next year or so. One piece of evidence supporting the buoyancy within the economy is the ongoing acceleration in unit labour costs: a closely monitored statistic by the authorities.

SINGAPORE: MONEY MARKET & BALANCE OF PAYMENTS



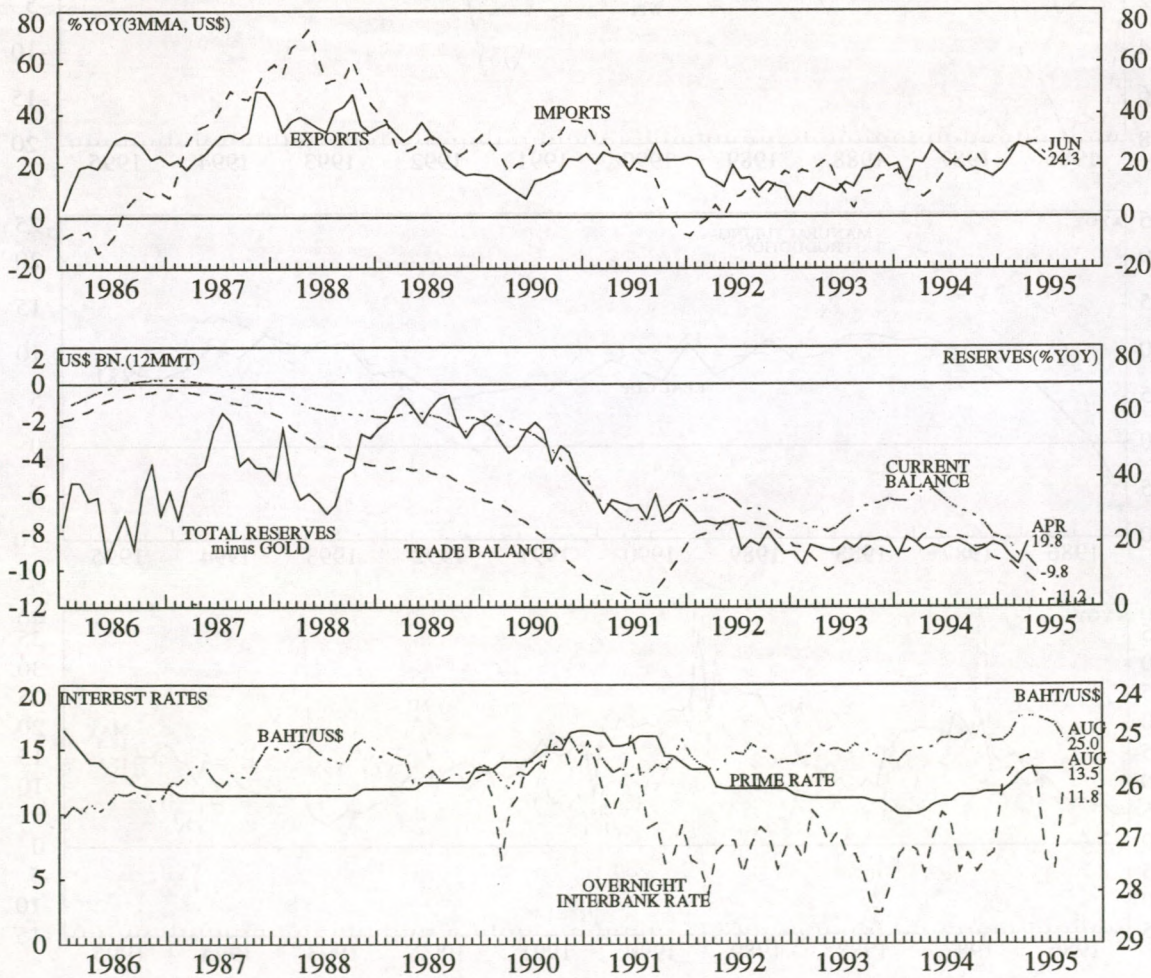
SINGAPORE: MONEY, OUTPUT, GOODS & ASSET PRICES



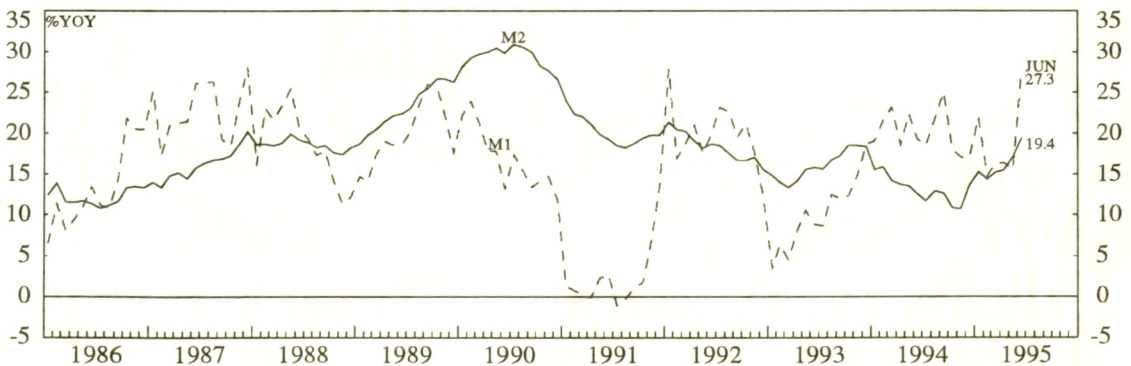
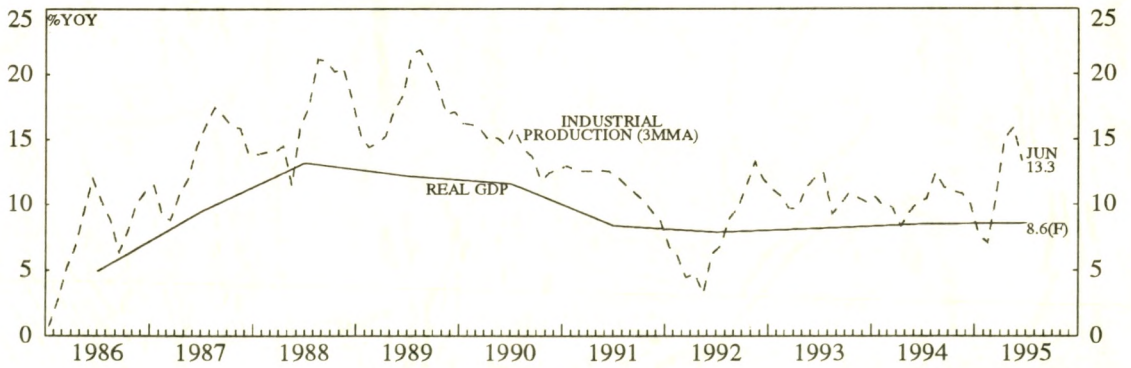
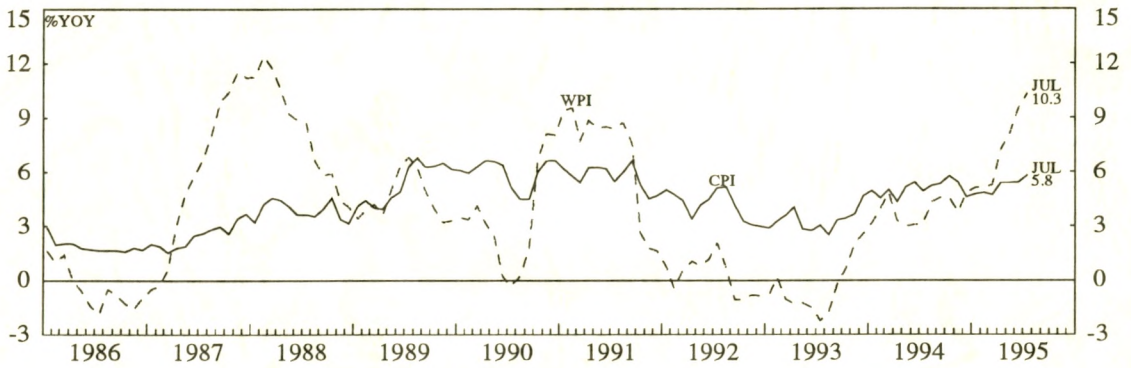
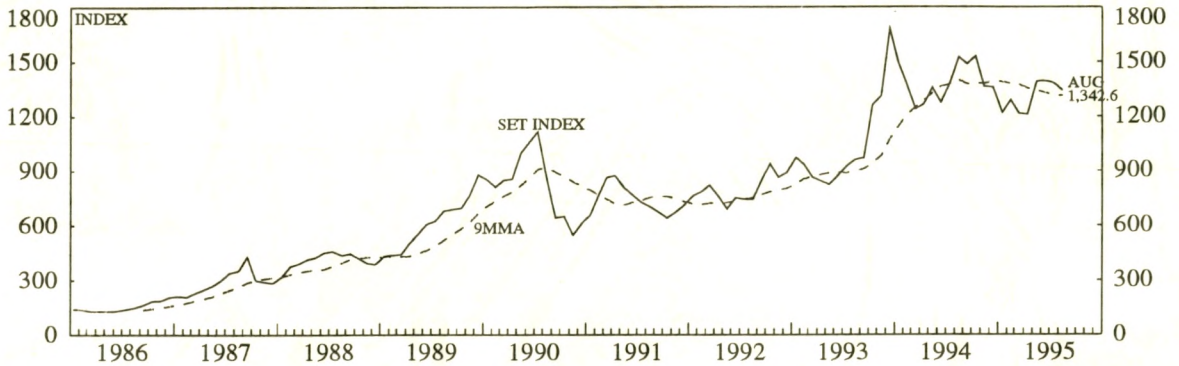
THAILAND: REINFORCEMENTS IN THE FIGHT AGAINST INFLATION

Bank of Thailand's announcement (20 July), of further measures to tighten liquidity, against the backdrop of rising inflation, and further deterioration in the trade balance, were largely discounted by the equity market. The measures included: (i) raising of the cash component of reserve requirements on non-resident Baht deposits and (ii) a program of ThB 30bn in Government bonds issues. So far the latter have been heavily oversubscribed at average rates around 8.0%, suggesting an imminent upward yield curve shift in the near future. Rising bond yields and monetary tightening will be negative for the stock market over the next twelve months, as will any further action by the BOT, promised in the event that the most recent measures fail to work. On the whole, the new measures will act to soften growth (slightly) this year, but are unlikely to impact significantly on the negative inflation and trade outlook. Broad Money (M2) has accelerated through 1995, in line with credit growth, and other indicators suggesting robust consumption growth. While export growth has moderated a little, the balance of payments remains more than comfortably funded (Japanese FDI continues to grow). The Baht basket has remained steady in effective terms, and recent strength of the dollar will help dampen the inflationary impetus.

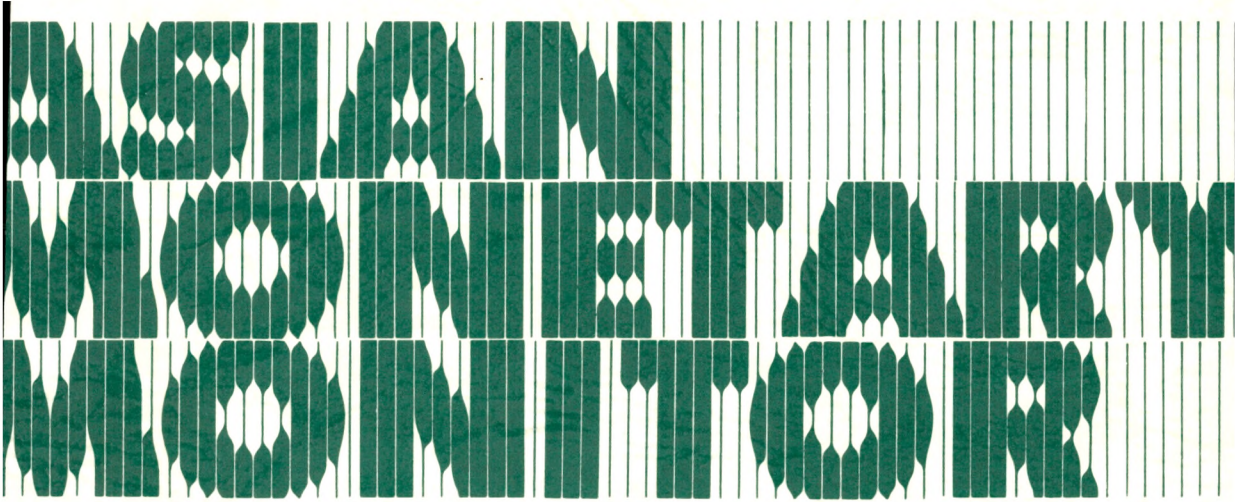
THAILAND: MONEY MARKET AND BALANCE OF PAYMENTS



THAILAND: MONEY, OUTPUT, GOODS & ASSET PRICES







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OVERVIEW THE ASEAN BUSINESS CYCLE OVERHEATS

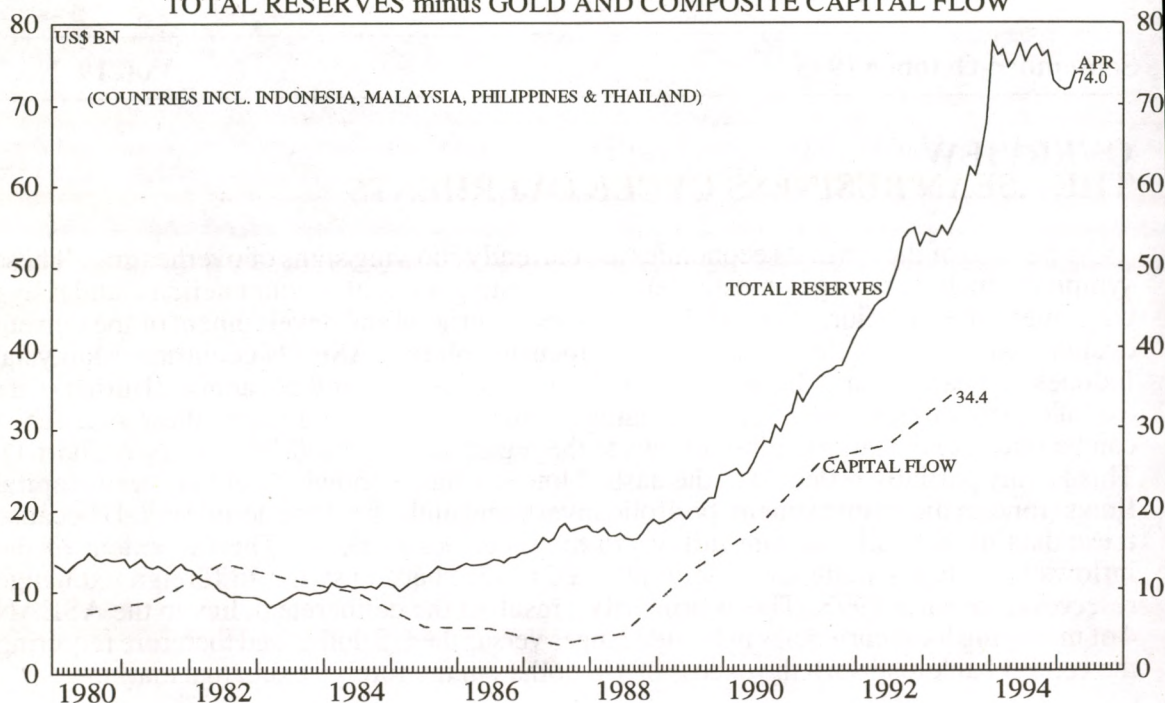
Several of the ASEAN economies are currently showing signs of overheating. These symptoms include strong domestic demand, widening current account deficits, and rising consumer price inflation. This article examines the origins and development of the current cyclical expansion for the ASEAN region, focusing on four ASEAN countries: Malaysia, Indonesia, Thailand and the Philippines (Singapore, Brunei and Myanmar (Burma) are excluded from this survey). The beginnings of the present difficulties of these ASEAN 4 can be traced to the large capital inflows to the region in the period 1992-93 (see Chart 1). This is only partially reflected in the dashed line in Chart 1 showing net long-term capital flows (foreign direct investment, portfolio investment and other long-term capital) because these data do not fully capture inflows to the securities markets. The full extent of the inflows is probably more accurately reflected in the sharp upswing in foreign exchange reserves from early 1993. This is primarily a result of the deliberate policy in the ASEAN 4 of managing local currencies in limited ranges versus the US dollar, and therefore requiring the central bank to absorb the excess of US dollars in the foreign exchange market.

The impact of the purchases of foreign exchange by the central banks of the ASEAN 4 can be seen in the behavior of the aggregated monetary base for these countries, shown in Chart 2. After a sharp slowdown in 1991 and in late 1992/early 1993, the combined growth rate of the monetary bases accelerated from 11% in mid-1993 to over 25% by the end of 1994. This followed directly from the upswing in the growth of foreign exchange reserves from 10% to 40% over the same period. The rise in the consolidated base was not as great for two reasons. First, bank reserves account for only a small proportion of the ASEAN 4's monetary base (the remainder being cash currency held by the public and the banks). Second, sterilization operations by the central banks of the ASEAN 4 either wholly or partially offset the inflows of foreign exchange. For example, sales of Bank Negara bills by Malaysia's central bank absorbed some of the ringgit created by the central bank's initial purchases of foreign exchange.

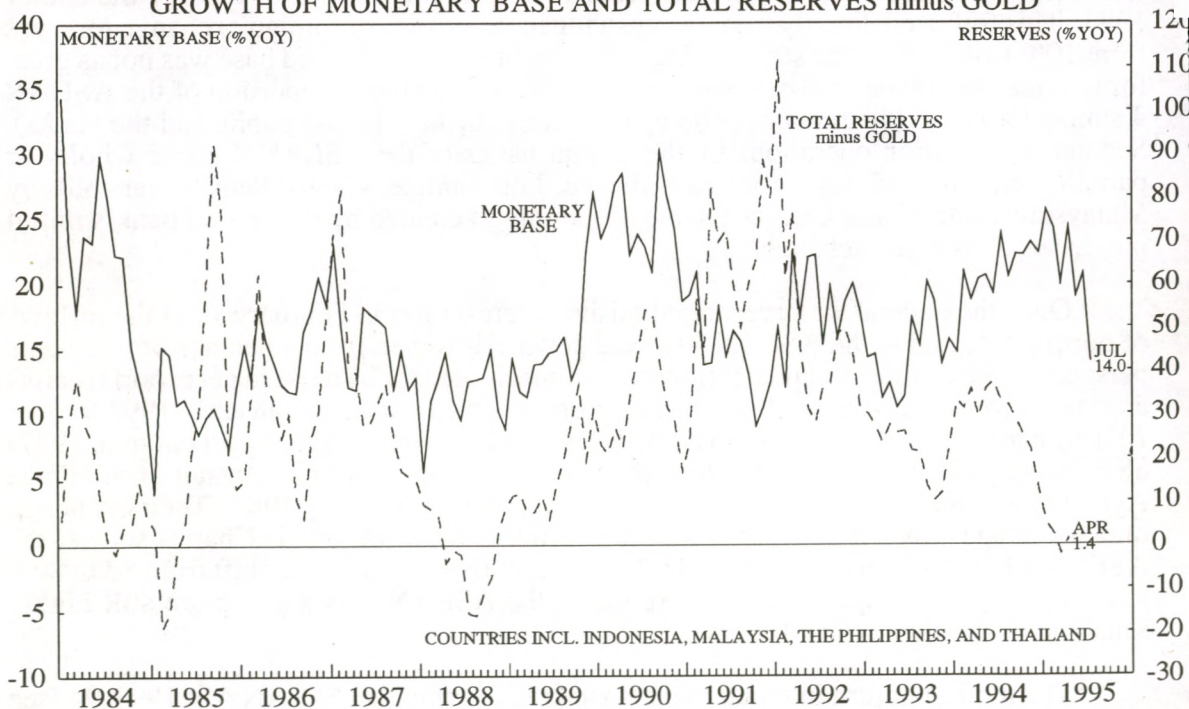
Once the Federal Reserve started raising interest rates in February 1994 the inflows of portfolio capital to the ASEAN 4 slowed down. However, from a balance of payments perspective the decline in capital inflows was compensated for by a rise in net export receipts as exports from the ASEAN 4 accelerated from around 10% growth in early 1994 to over 25% by early 1995 (see Chart 3). The ASEAN 4 had enjoyed a huge export boom in 1987-88 following the weakening of their real effective exchange rates as a result of the Plaza Agreement of September 1985 and the Louvre Accord of February 1987. Their exchange rate advantage was not as great in absolute terms in 1994-95, but as Chart 3 shows, the ASEAN 4 have only given up about 10% in competitiveness (i.e., the shift from 83 to 89.4 since 1989). This implies that the exports of the ASEAN 4 as a group are still highly sensitive to stronger demand overseas.

The modest upturn in broad money and credit within the ASEAN 4 in 1993-94 (see Chart 4) is a tribute to the successful sterilization operations of their central banks. However,

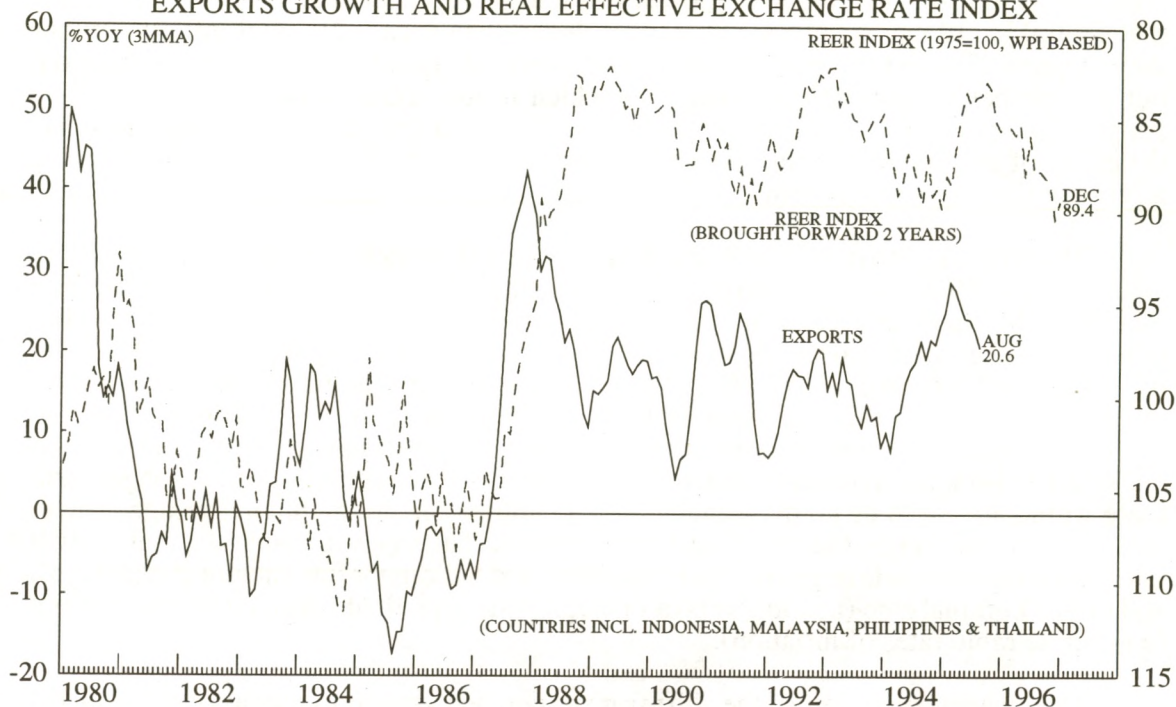
OVERVIEW: CHART 1
TOTAL RESERVES minus GOLD AND COMPOSITE CAPITAL FLOW



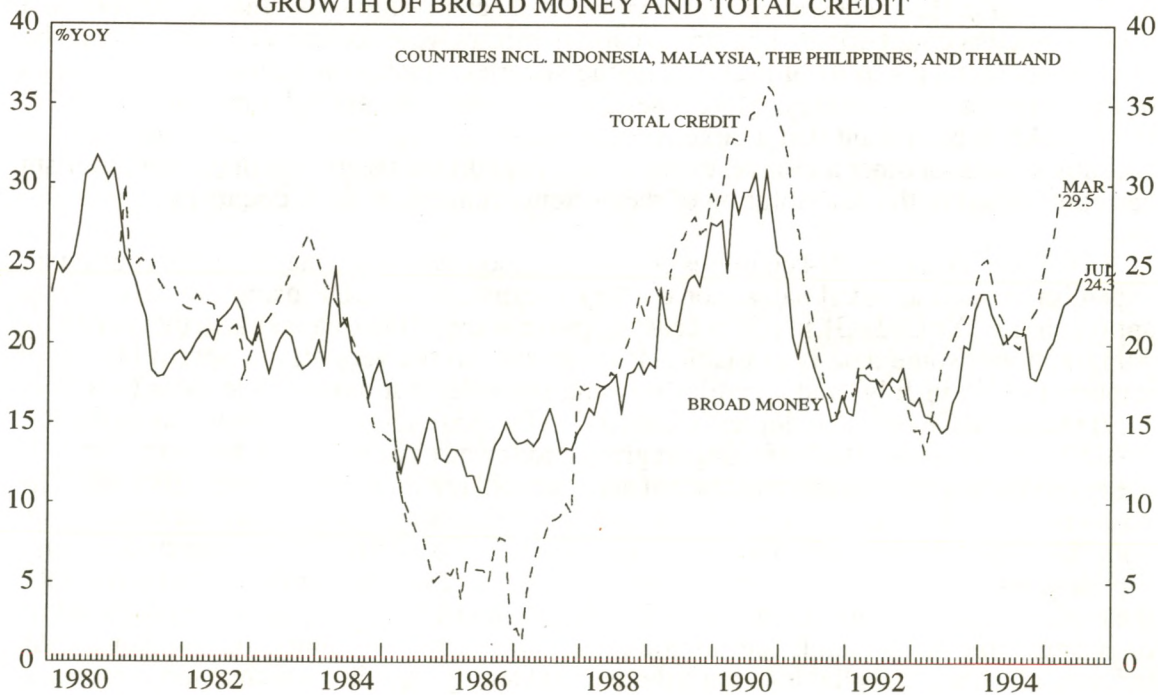
OVERVIEW: CHART 2
GROWTH OF MONETARY BASE AND TOTAL RESERVES minus GOLD



OVERVIEW: CHART 3
EXPORTS GROWTH AND REAL EFFECTIVE EXCHANGE RATE INDEX



OVERVIEW: CHART 4
GROWTH OF BROAD MONEY AND TOTAL CREDIT



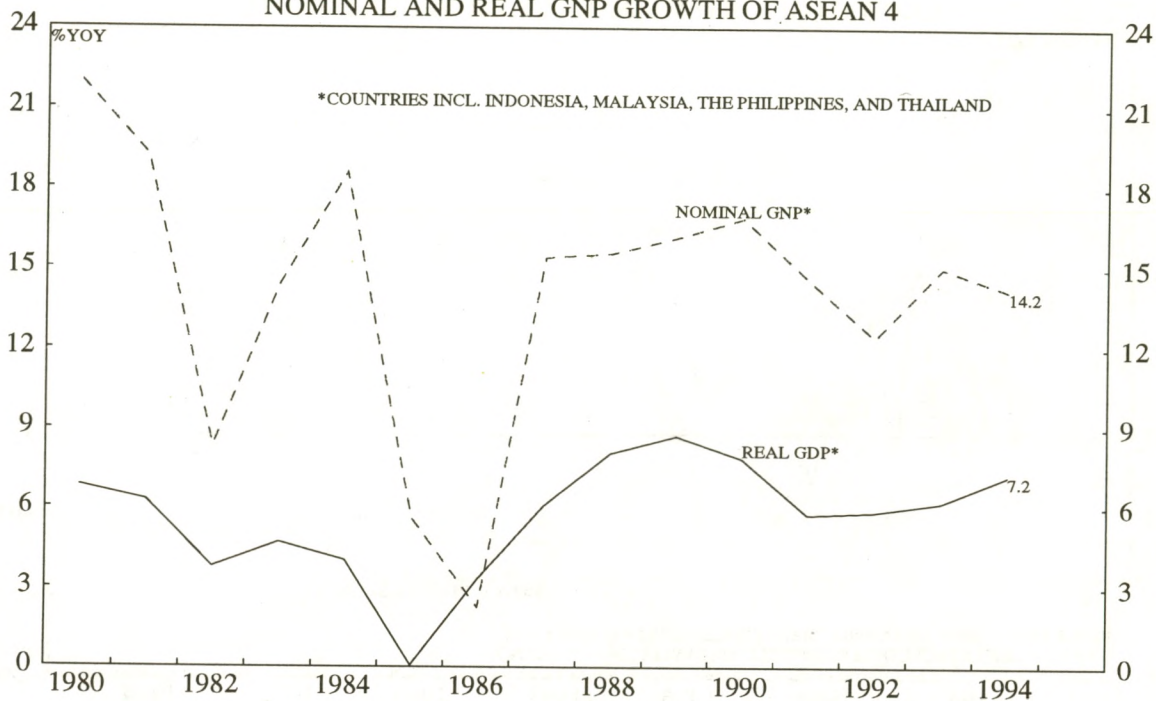
they have been markedly less successful in 1995 as domestic demand generally picked up, credit demand rose, and monetary growth was allowed to accelerate again. The reason is that central banks can suppress only part of the consequences of capital inflow -- either they suppress the quantitative result (i.e. the increase in the quantity of money) by sterilization, but that pushes up domestic interest rates which in turn attracts more inflows, or they suppress the price effect (i.e., the appreciation of the local exchange rate) which also has the effect of not lowering domestic rates, again attracting further flows which otherwise might not flow into the economy.

The overall pattern of the ASEAN 4's real GDP growth has been comparatively stable since 1990. Compared with the fluctuations in the aftermath of the 1981-2 recession including the sharp downturn in 1985, recent experience has been a model of stability (Chart 5). Combined real GDP growth slowed from 8.7% in 1989 to 5.7% in 1991, and has subsequently recovered to 7.2% in 1994. The slowdown in nominal GNP (from 16.9% in 1990 to 12.4% in 1992) was somewhat greater, with the extra 2% fall coming from the decline in inflation. However, despite the comparatively modest upturns in real and nominal GDP in 1994-95, the symptoms of overheating are now substantial. For the longer term there would appear to be no reason why these countries can not maintain average growth rates in the 6-9% range, but they clearly face serious challenges in managing that growth rate both on the real side (e.g. in terms of planning and building infrastructure fast enough), and on the nominal side (i.e., in terms of managing the growth of financial flows so as not to generate rapid rates of inflation).

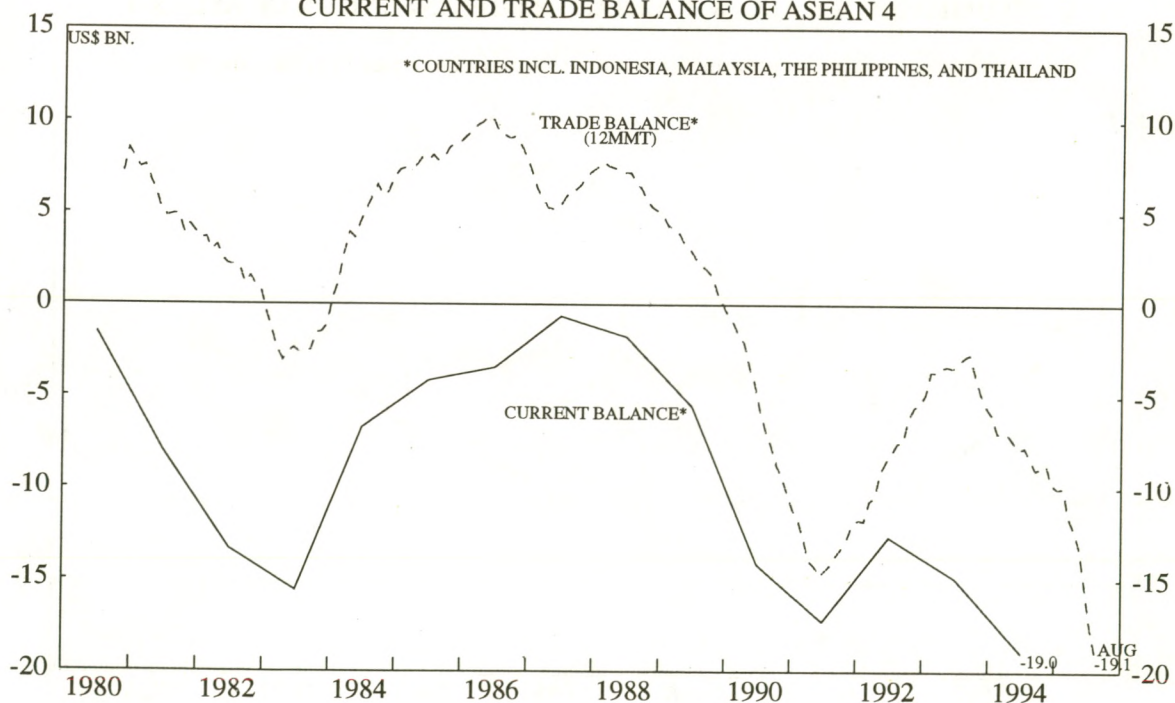
The clearest symptom of the shift from export-led growth to domestic demand-led growth is the sharp deterioration in the combined trade and current account balances of the ASEAN 4 shown in Chart 6. The slowdown in activity and the associated cooling off of inflation led to a short-lived upturn in the combined trade account in 1991-93, but only a one-year improvement in the combined current accounts (in 1992). Since then the deterioration in the trade and current accounts has been continuous. Initially it was, in a sense, capital account driven, i.e., strong capital inflows were accompanied or followed by imports of capital goods to build and equip the factories which would generate future flows of foreign exchange earnings. More recently the growing strength of domestic demand in the ASEAN 4 has meant that a larger proportion of imports have been accounted for by consumer goods or other non-investment goods. In addition, the growth of outward tourism has contributed to the deterioration of the current accounts of these countries.

Some of the ASEAN 4 countries do not have good data on the major items of consumer expenditure such as retail sales, nor do they compute their GDP using the expenditure approach (i.e., $Y=C+I+G$), so it is not easy to prove some of the statements in the preceding paragraph, but some data is available. It is clear from the very strong upturn in overall imports (+34% in July) and a similarly strong upswing in motor vehicle sales (+30% in July) shown in Chart 7 that domestic demand in the ASEAN 4 is booming. As in the last ASEAN export boom (1987-88), import growth followed closely behind, but in that episode the deterioration in the trade and current accounts did not really occur until 1989-90. The problem, on this occasion, is that the import surge has occurred virtually simultaneously with the export boom, with the result that instead of benefiting from a period of easy liquidity, rising asset prices, soft domestic demand, and improving balance of payments, these phenomena had already occurred in 1992-93, and 1994-95 has seen the combination of strong domestic demand, deteriorating trade and current accounts, and weaker capital inflows, all of which is liable to contribute to tightening liquidity which could threaten to undermine asset prices.

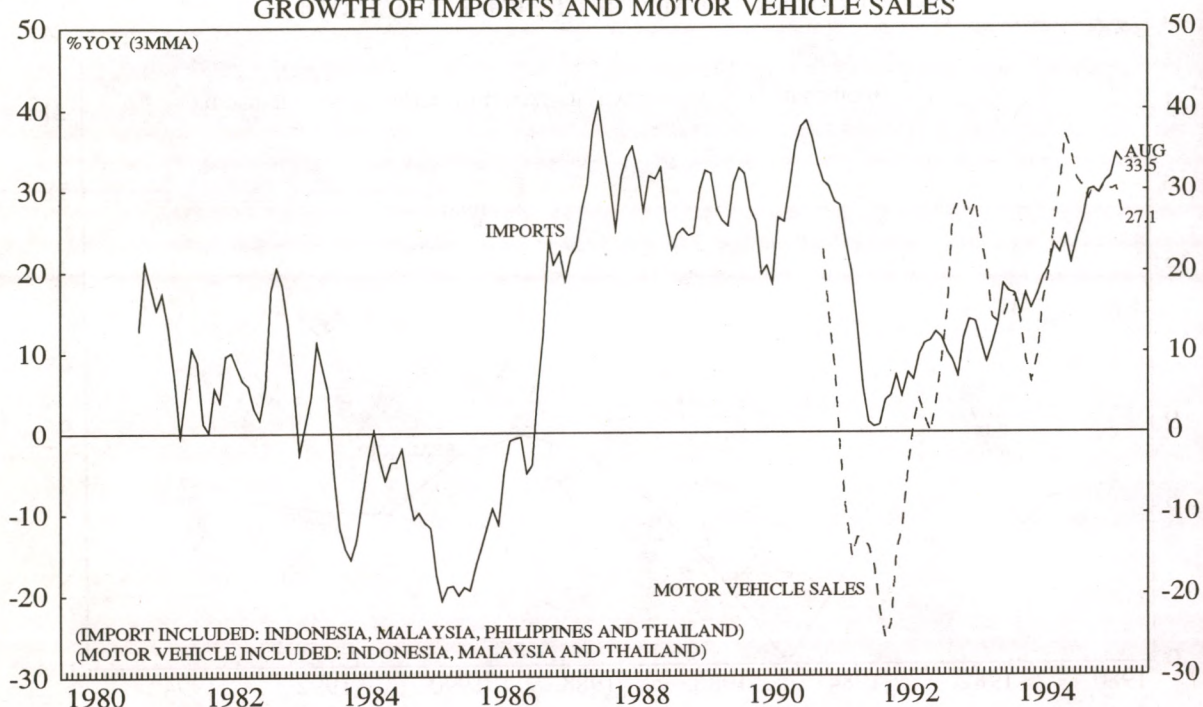
OVERVIEW: CHART 5
NOMINAL AND REAL GNP GROWTH OF ASEAN 4



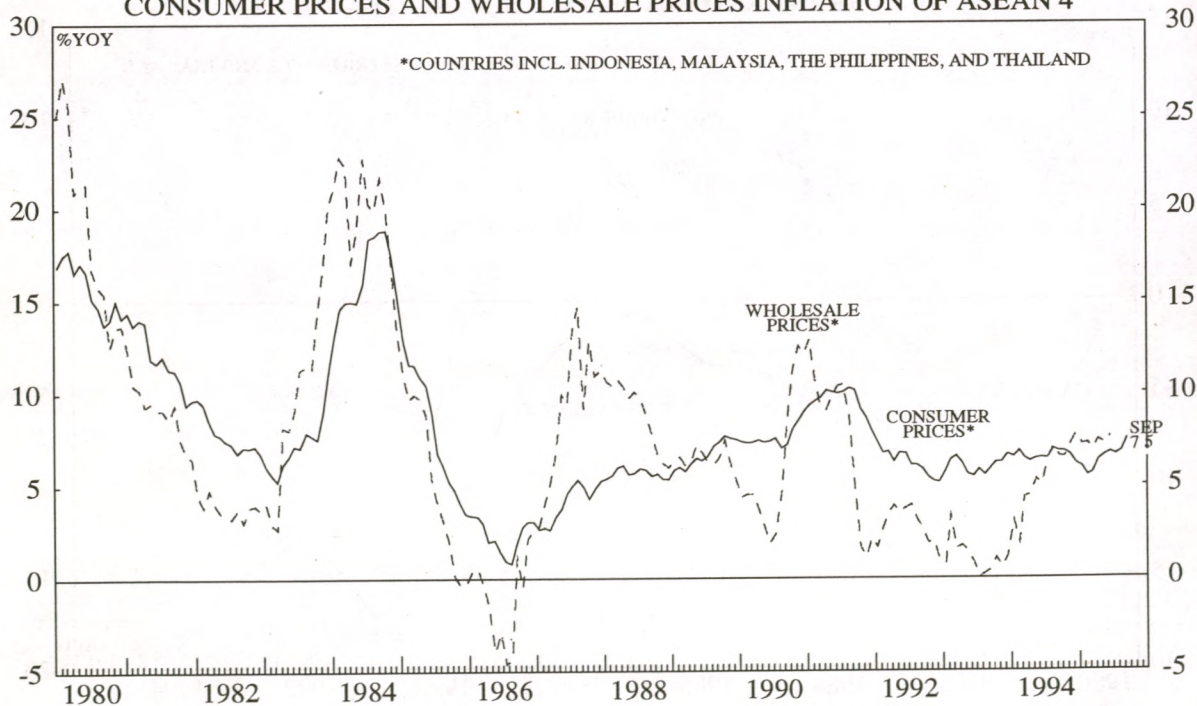
OVERVIEW: CHART 6
CURRENT AND TRADE BALANCE OF ASEAN 4



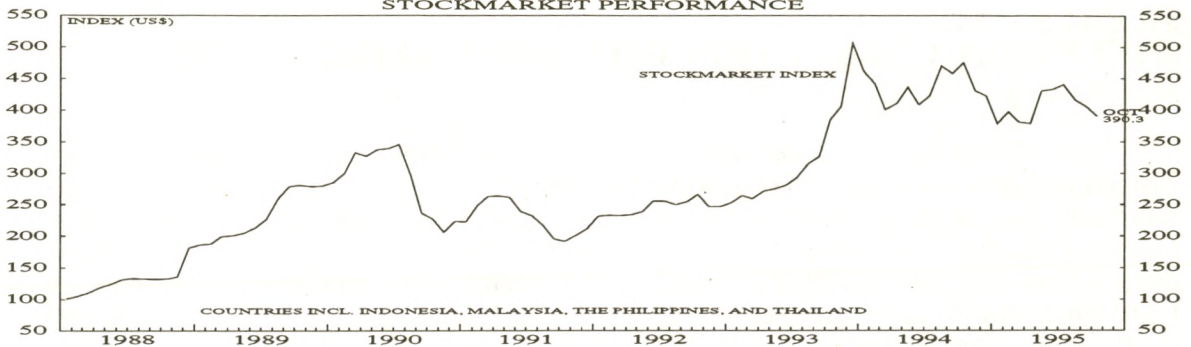
OVERVIEW: CHART 7
GROWTH OF IMPORTS AND MOTOR VEHICLE SALES



OVERVIEW: CHART 8
CONSUMER PRICES AND WHOLESALE PRICES INFLATION OF ASEAN 4



OVERVIEW: CHART 9
STOCKMARKET PERFORMANCE



Normally a rise in CPI inflation marks the final stages of a domestic demand boom. To date, as shown in Chart 8, the rise in the aggregate CPI of the ASEAN 4 has been very modest, but the direction of change is clearly indicated by the strong upswing of the WPI since early 1994. In some of the ASEAN 4 explicit price controls on major consumer staples (e.g., in Malaysia and Indonesia) obviously distort the CPI, disguising the true amount of inflation in the system. Based on the behavior of broad money, however, this episode of inflation should not be expected to be as serious in overall terms as the 1990-91 acceleration in inflation since that episode was preceded by a substantially greater upswing in broad money. If, however, governments or central banks in the ASEAN 4 are reluctant over the next few quarters to raise interest rates sufficiently to curtail loan demand and hence monetary growth, then there could be a repeat of 1989-90 monetary surge with comparable inflationary consequences.

The stock markets of the ASEAN 4 participated fully in the global emerging markets boom of 1993, with Malaysia and the Philippines performing particularly strongly. When the Fed started raising the Fed funds rate from February 1994 all four markets corrected, but there were good rallies in the Philippines, in Thailand and in Malaysia during part of 1994 (see Chart 9). Also, in 1995 all four markets have seen modest rallies, but none as strong as the bull market in the USA. This is despite 25-30% export growth and strong domestic demand growth -- both of which have been supportive for earnings growth. The problem is that the ASEAN 4's monetary authorities have been reluctant to address the problems of overheating head on, preferring perhaps to hope that the situation will gradually improve as growth continues and inflation dissipates. However, with the US having now accomplished a successful transition to slower growth with falling inflation, the ASEAN 4 are in danger of being left with the overhang of the 1993 euphoria in the shape of higher inflation and weaker current accounts through 1995 and well into 1996. These problems should not be exaggerated, but the capacity of the ASEAN 4 to participate in the upswing during the second stage of the US business cycle expansion will be limited by the continuing need to correct the problems which arose from the first stage of the US expansion. Stronger action on interest rates and money and credit growth would set the scene for a better financial climate in 1996-97.

FORECAST : The ASEAN 4 share common characteristics in terms of the phase of their business cycles. They all benefited from capital inflows, easy liquidity and rising asset prices in 1993. As the capital inflows slowed in 1994, they were replaced in balance of payments terms by strong export growth. However, at the same time domestic demand booms got under way. As a result, the ASEAN 4 are now showing many symptoms of overheating: strong domestic demand, worsening trade and current accounts, and rising CPI inflation. These problems are not too severe, but they will require a period of consolidation via higher domestic interest rates and slower money and credit growth if the ASEAN 4 are to participate fully in the 1996-97 phase of global expansion.

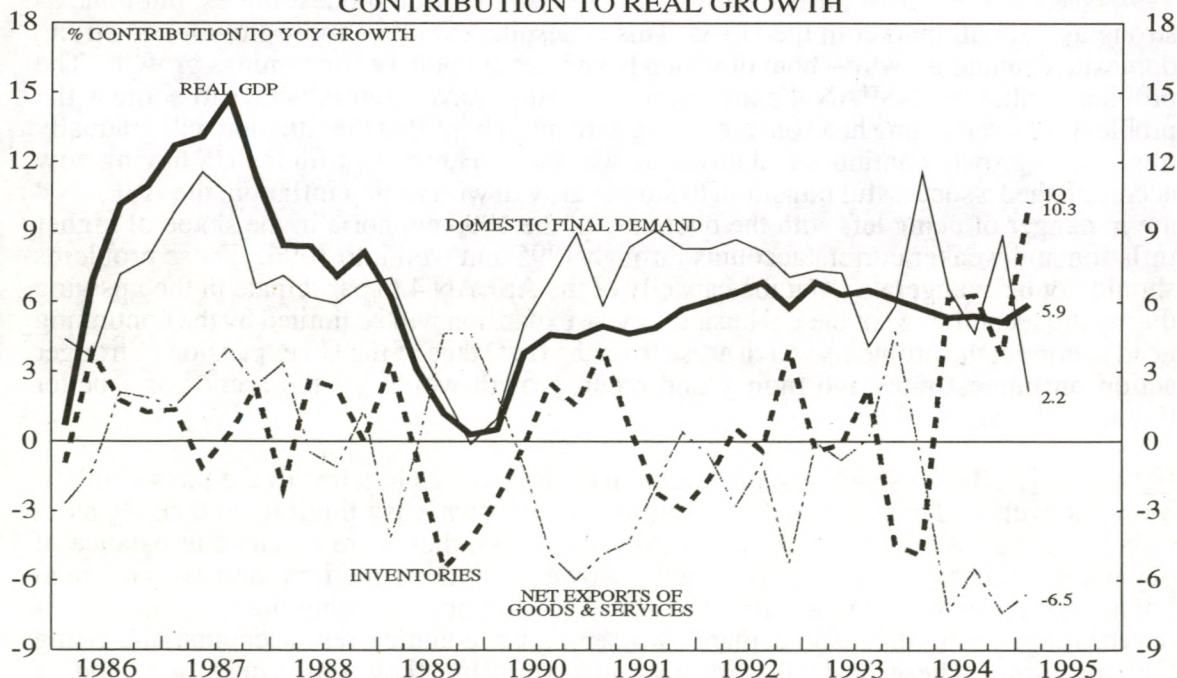
HONG KONG INVENTORY CORRECTION WILL SLOW GDP GROWTH

Since Hong Kong's stockmarket corrected in early 1994, there has been a sense of economic downturn in Hong Kong, which has not yet been reflected in the headline GDP numbers. Indeed the year-on-year growth rate of GDP has accelerated to 5.9%, while historical data have been subject to upward revisions as data coverage has improved. However, behind the latest figures are some disturbing trends in the individual components of GDP which could well exert a severe negative impact on the aggregate GDP growth rates for the remaining quarters of 1995 and into 1996.

Inventory-led GDP Growth

If we break down GDP broadly into external demand, domestic final demand and changes in inventories, we find that while the first two components have slowed significantly since the beginning of 1994, this slowdown in final sales has been cushioned by a significant accumulation of inventories. Indeed the year-on-year contribution of inventory accumulation exceeded the overall rate of GDP growth in the second and third quarters of 1994 and in the first quarter of 1995 for the first time in over ten years. In other words, for those three quarters the year-on-year growth rate for Gross Domestic Final Sales (GDFS=GDP excluding inventories) was negative, and to the tune of -4.2% in the first quarter of 1995. While in larger economies, economists and other commentators often examine GDFS and inventories separately to get a clearer picture of the business cycle; one can argue that in the context of the small open economy of Hong Kong inventories reflect volatility in external trade (which is 2.8 times the size of GDP) and should be included in any measure of the underlying strength of the economy which also includes external trade.

HONG KONG: CHART 1
CONTRIBUTION TO REAL GROWTH



However, the contribution to GDP growth from inventory accumulation in the first quarter of 1995 was of extreme magnitude (a record 4 standard deviations away from the historical average) and merits some further explanation, in order to understand if the inventory boom will continue, tail off or be sharply reversed.

The Change in Inventories is the value of physical change in stocks (i.e. excluding valuation effects) in all parts of the economy, but mainly in manufacturing, wholesaling, retailing and construction. For GDP accounting purposes in Hong Kong service sectors are assumed to have unchanging inventories. Six sources of inventory accumulation would appear to have contributed to the recent inventory boom:

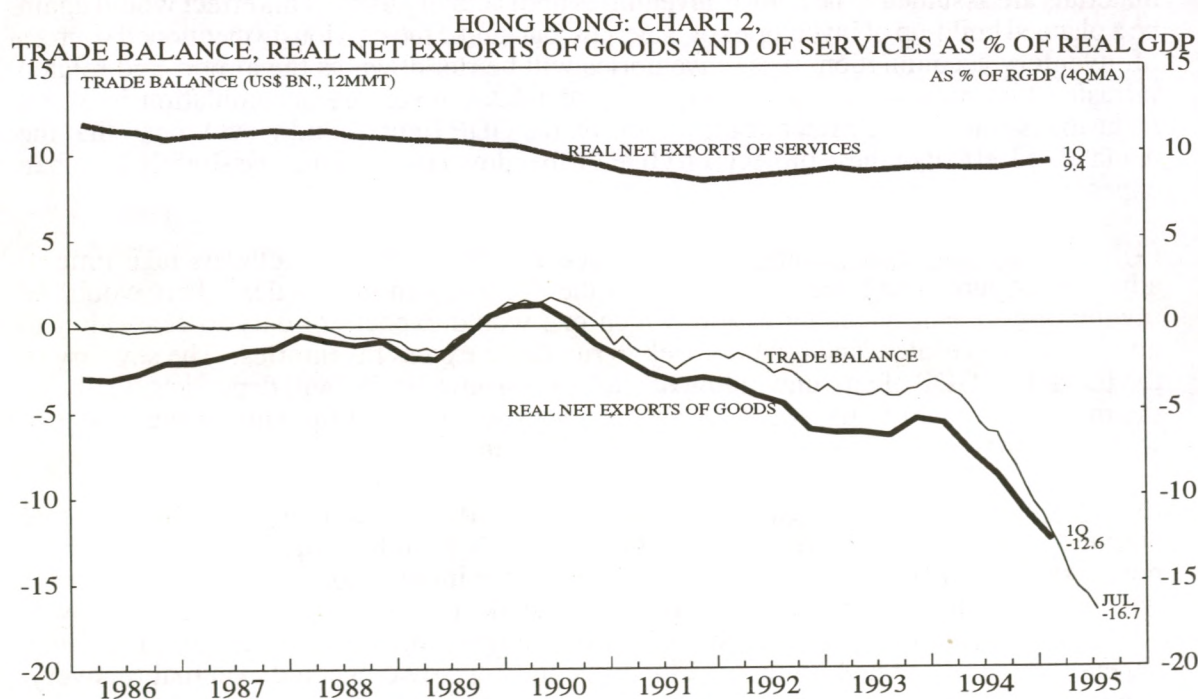
- (1) Base effect from inventory rundown in first quarter of 1994, when exceptionally strong retail sales (probably buoyed by record bonuses at end-1993) caught retailers and wholesalers short. This base effect would have been a planned rebuilding of inventories to normal levels, which (once completed) one would not expect to further contribute to or subtract from overall GDP growth.
- (2) Commodity price volatility effect, as increasing commodity price volatility prompts manufacturers and wholesalers to hold a higher level of precautionary inventories to hedge against future supply uncertainty. However, given the cost of capital and storage space in Hong Kong and the increasing availability of non-physical means of hedging (i.e. commodity futures and derivatives) it seems unlikely that this was a major source of inventory accumulation. Insofar as it contributed, it can be viewed as a one-off shift in the planned levels of stocks, which (once reached) one would not expect to further contribute to or subtract from overall GDP growth.
- (3) Airport effect, given the substantial imports of machinery and materials to build the new airport and related infrastructure. Machinery is assumed to be used straight away, but materials are assumed to be held as inventories until actually used. This effect would again be a planned build-up of inventories of materials, but unlike the previously mentioned sources of inventory accumulation, these inventories will be run down as the airport and related infrastructure projects are completed. Airport related inventory accumulation in effect front-loads some of the effect of the airport on the GDP figures, and would mean that the demand-side effect of these projects on GDP further down the road may be slightly less than expected.
- (4) Domestic Consumption downturn effect, as wholesalers and retailers take time to adjust their purchasing decisions to reflect the downturn in retail sales. This would be involuntary inventory accumulation, which one would expect not only to cease, but to unwind as wholesalers and retailers seek to run down excess inventories. The severity of the impact on GDP of any unwinding of such excess inventories will depend critically on the magnitude and timing of a recovery in domestic consumption, and on the extent to which it is offset by a slowdown in import of consumer goods.
- (5) China Slowdown effect, accumulation of imported goods and domestic industrial output intended for re-export to China, but which has been held up due to China's economic slowdown and the clampdown in China on the importation of certain goods. This would be involuntary inventory accumulation (just like the Domestic Consumption downturn effect) which one would expect to cease and unwind. The severity will of course depend on the extent and timing of China's economic slowdown and eventual recovery, and on the extent to which this is offset by a slowdown in imports for re-exports.

(6) Statistical error. Hong Kong's expenditure-based GDP figures are compiled on a commodity flow basis. Every good and service which is produced in or imported into the economy must be consumed, invested, exported or accumulated as inventory. In other words, changes in inventories are calculated as the residual after GDP has been apportioned to all the final expenditure components, rather than by adding up the levels of inventories held by all agents in the economy. Given the volatility of the trade statistics, and especially the capital flows hidden within the trade balance by the changing invoicing practices of China enterprises, there is plenty of scope for errors to accumulate. Errors caused by capital outflow from Hong Kong to China through misvalued trade flows should not be counted in the GDP, but would mean that the trade deficit (excluding capital outflows) would be smaller in line with the smaller degree of inventory accumulation, with zero net effect on GDP. Other types of error may, however, have led to an overestimation of GDP growth.

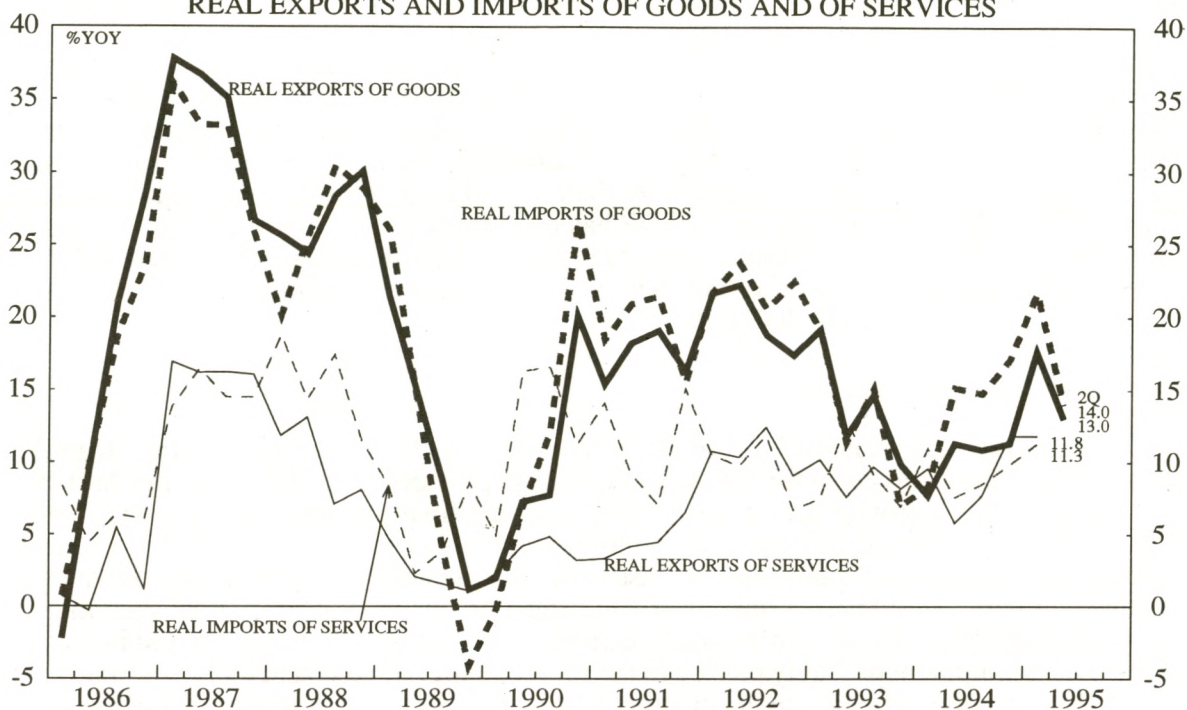
Balancing these different factors, one would expect that a significant proportion of the recent inventory accumulation would have to be unwound in the near term future. While factors (1) and (2) will cease to provide much contribution to GDP growth, and the contribution from (3) will tail off and gradually unwind over the duration of the airport project, the contribution from (4), (5) and possibly (6) looks set to turn negative, with the severity depending on the strength of other components of GDP.

Net Exports Dragging Down GDP Growth

Chart 1 showed that the contribution from net export of goods and non-factor services to year-on-year growth in real GDP had been negative since the first quarter of 1994. As can be seen from chart 2, Hong Kong has traditionally had a strong and stable surplus on trade in services which historically had more than outweighed cyclical deficits on the merchandise trade balance. Recent deterioration in the merchandise trade balance has, how-



HONG KONG: CHART 3
REAL EXPORTS AND IMPORTS OF GOODS AND OF SERVICES



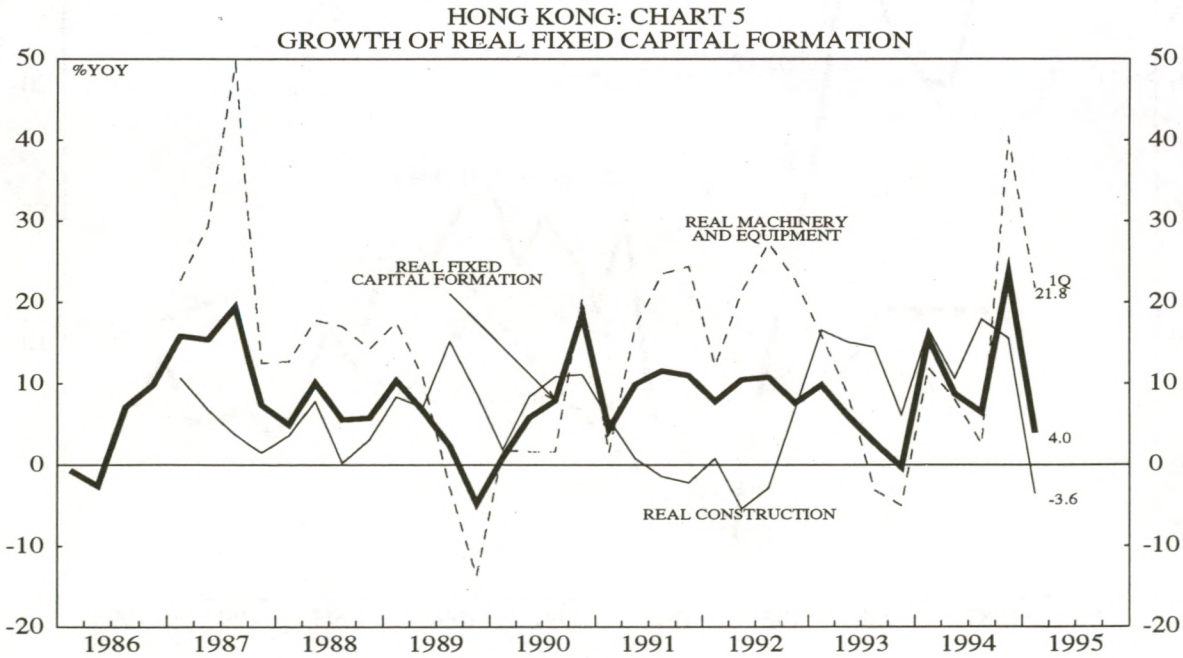
HONG KONG: CHART 4
GROWTH OF REAL RE-EXPORTS OF GOODS AND CHINA REAL GDP



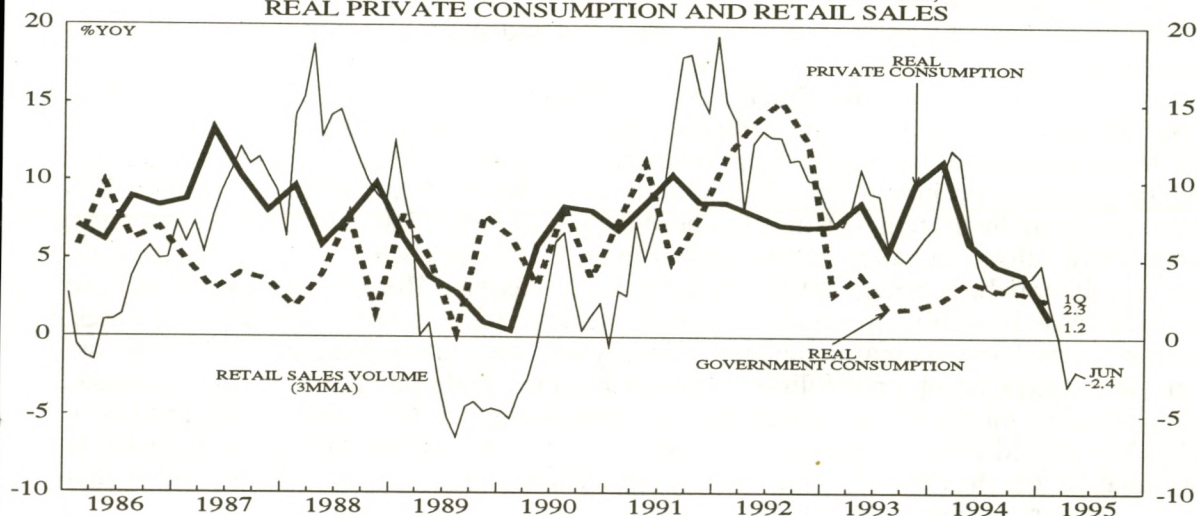
ever, meant that the deficit on real net exports of goods has come to exceed significantly the surplus on real net exports of services, and looks set to be an even heavier drag on year-on-year GDP growth in the second and third quarters of 1995. Chart 3 shows the same information in terms of year-on-year growth rates of real imports and exports of goods and of non-factor services, with import growth significantly exceeding export growth since the first quarter of 1994. More than 80% of Hong Kong's total exports are re-exports, over 90% of which are either of Chinese origin or destined for China; in other words, the gross value of re-export trade with China is more than the value of Hong Kong's overall GDP. Chart 4 shows that this component of GDP has been fairly closely correlated to China's economic growth. We think China is unlikely to recover significantly until the second half of next year, and therefore we do not view this as a likely source of growth for Hong Kong's re-exports or overall GDP in the near term.

Airport Buoys Up Investment

The airport and related infrastructure projects have helped buoy up investment, and looks set to continue to do so for the duration of these projects. The slowdown in Chart 5 in the year-on-year growth rate of investment from the final quarter of 1994 to the first quarter of 1995 seen was in large part due to the base effect of the same quarters a year earlier. However, even netting out the base effect and volatility, a modest slowdown is evident compared with the first quarter of 1992 and 1993, in spite of substantial spending on the new airport and related infrastructure projects. While growth in investment in machinery and equipment probably peaked in the fourth quarter of 1994 and looks set to slow further, the negative growth rate in construction recorded in the first quarter of 1995 may well be a one-off as the investment in machinery and equipment and inventories translates into a prolonged period of stronger than usual construction activity. Although private construction is in a downswing in line with conditions in the property market, this will be offset by continued strong public construction activity. On balance we expect overall investment growth to remain steady at 5-10% yoy for the remainder of the year, but not to return to strong growth rate of the fourth quarter of 1994.



HONG KONG: CHART 6
GROWTH OF REAL GOVERNMENT EXPENDITURE,
REAL PRIVATE CONSUMPTION AND RETAIL SALES



Consumption Slowdown Continues

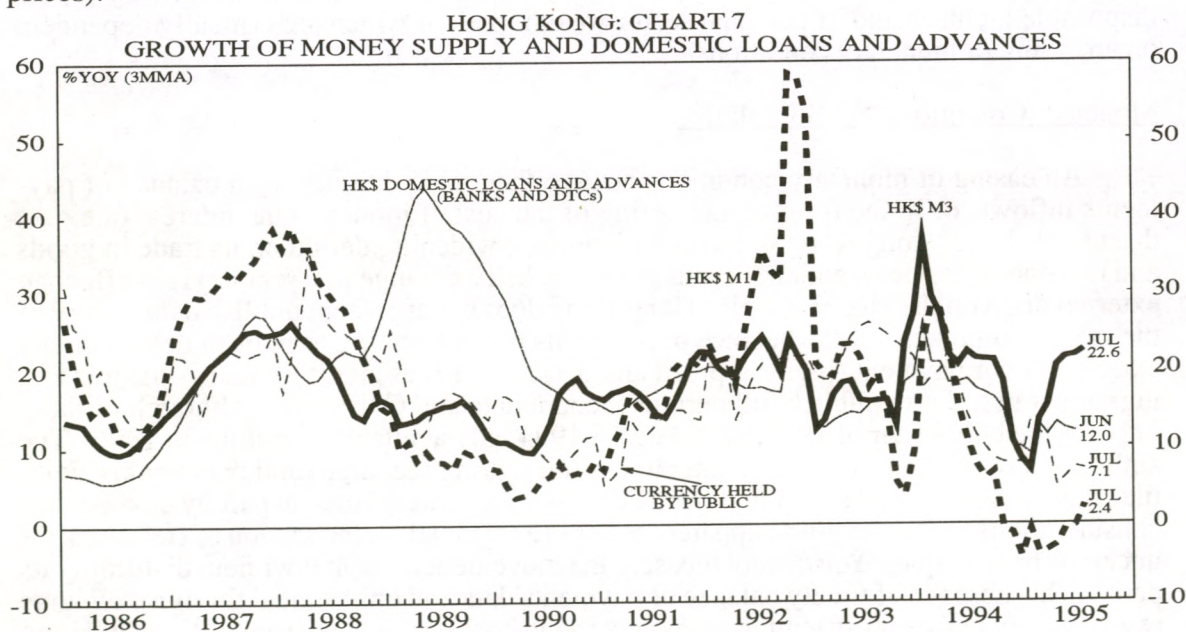
Government consumption expenditures are a stable and only relatively small proportion (7.5%) of GDP and have been growing at a slower rate than overall GDP for the past two years, as a greater proportion of government spending has gone into investment rather than consumption. Private consumption expenditures, on the other hand, account for 60% of GDP, and have been slowing down considerably since the beginning of 1994 in line with the slowdown in retail sales. Retail sales volumes have in fact slowed down even further and recorded negative year-on-year growth rates in most months in the first half of 1995, suggesting that private consumption is likely to be flat or possibly decline in year-on-year terms in the second quarter. Looking further ahead, private consumption is unlikely to resume its previously strong growth path until we have an unambiguous recovery in real disposable incomes and/or personal sector wealth, both of which are critically dependent on an easing of monetary conditions.

Monetary Conditions Not Stimulative

An easing of monetary conditions could either come directly from balance of payments inflows, or in the form of a lowering of the cost of money -- the interest rate. As discussed above, Hong Kong is currently running a widening deficit on its trade in goods and non-factor services, which (because of the linked exchange rate regime) is in effect an external drain on the money supply. Hong Kong does not at present publish data on any of the other components of the balance of payments but is planning to publish details on net external factor payment (interest, profit and dividend) flows later this year -- the missing ingredient in order to publish full current account data and GNP data -- although initially only for the boom year of 1993, with data for 1994 only available sometime in 1996. The authorities still appear to have no intention of measuring the large (and presumably volatile) flows on the capital account of the balance of payments, guided in part by cost-benefit considerations and in part by an apparent belief in a financial sector version of Heisenberg's uncertainty principle: 'You cannot measure the movement of capital without disturbing its path'. This absence of timely balance of payments data and only annual foreign exchange reserves data makes it difficult to assess external shocks to monetary conditions in Hong Kong.

Looking at Hong Kong's rather volatile credit and money aggregates in chart 7, we notice that although both HK\$ loans and advances, HK\$ M1 and currency held by the public have slowed significantly since early 1994 and suggest that monetary and credit conditions are not stimulative. However, HK\$ M3 has (adjusting for the base effect of nearly 40% yoy growth in the first quarter of 1994) been growing steadily at around 20% year-on-year, suggesting that monetary conditions are not very tight. However, over the past year there have been some important institutional changes and market movements which may have prompted a portfolio-shift of Hong Kong private sector assets into HK\$ M3. The main institutional change has been the partial deregulation of HK\$ deposit rates, which now allows savers to access market interest rates in HK\$ M3 assets which could previously only be accessed in Foreign Currency M3 assets. The market movements have been increased volatility in equity prices and exchange rates and rising HK\$ interest rates, which has probably increased the precautionary and speculative demand for HK\$ M3 assets, at the expense of a portfolio-shift out of Equities, and Foreign Currency M3 assets. Therefore, given the above factors, the recent upswing and continued strong growth in HK\$M3 should not be taken as an indicator that monetary conditions are necessarily stimulative. On the contrary, other money aggregates suggest almost unambiguously that monetary conditions are fairly tight.

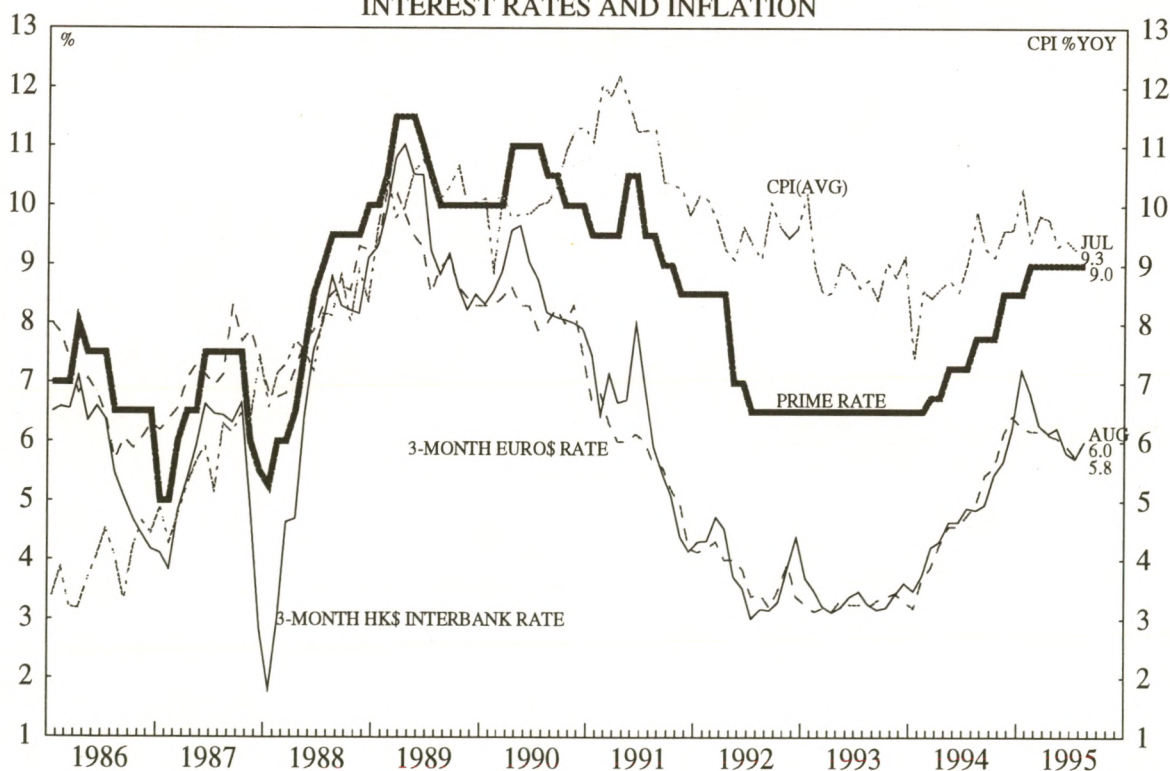
The slowdown in domestic loans and advances has in large part been due to a slowdown in mortgage lending. While just over a year ago the government introduced measures to curb speculation in the property market, they have now started relaxing their enforcement of the limits on property related lending to 40% of banks' total assets. Given the spectacular property price boom in the early 1990s, Hong Kong's property market may well still be overvalued, and such a relaxation of sensible prudential limits on banks' exposure to property may well be premature. However, the authorities are clearly worried about the implications of further falls in property values for government finances (a substantial part of government revenues is derived from land sales), for the financial system (property counters and banks with exposure to property comprise most of Hong Kong's stock market), and for the wider economy (potential negative wealth effect of further declines in property prices).



Hong Kong's short-term interest rates (see chart 8) have closely tracked US interest rates, following an upward path during 1994, and stabilising this year. Combined with a so far modestly declining rate of inflation, this has meant that the strongly negative real interest rates which fuelled the early 1990s asset price boom have now become significantly positive (mortgage rates = prime + 1.5%-2%, unsecured personal loans = prime + 3%-5%). Combined with the government anti-speculation measures mentioned above, the rise in real interest rates have not been positive for asset prices or economic expansion in Hong Kong. However, while short-term interest rates may well have stabilised for the time being, the rallies in US bond yields and equities in the first half of 1995 have helped support some rebound in Hong Kong equities.

Although short-term interest rates have closely tracked US interest rates, as one would expect under a linked exchange rate system, further out the yield curve a measurable risk premium has developed on HK\$ interest rates, especially for maturities straddling the mid-1997 transition to Chinese sovereignty. The 18 September auction of 5 year Exchange Fund notes resulted in an average accepted yield of 6.91%, 98 basis points above the yield on the benchmark 5 year US treasury bond. As 1997 draws nearer, this risk premium is likely to make itself felt at shorter maturities, resulting in tighter monetary conditions in the form of an increase in the cost of capital for HK\$ borrowers vis-a-vis US\$ borrowers. Depending on how well the authorities (both British, Hong Kong and Chinese) handle the situation to cement the credibility of the HK\$ link, and thus reduce the need for a HK\$ risk premium this may well constrain Hong Kong's monetary conditions and outlook for growth in the medium term.

HONG KONG: CHART 8
INTEREST RATES AND INFLATION



SUMMARY AND CONCLUSIONS: Inventory accumulation has accounted for an unusually high proportion of recent GDP estimates, and is likely to cease and be at least partially reversed. This likely inventory correction will only be partly matched by improvements in the trade balance and in construction activity, and will, together with continued slowdown in private consumption, lead to a significant slowdown of GDP growth to around 4% for 1995 as a whole. In addition, some involuntarily accumulated inventories may have to be written down rather than sold at a profit, thus impairing the profitability of trading companies and retailers.

Monetary conditions are not stimulative. Growth in HK\$M3 is deceptive as it includes portfolio shift into rising deregulated HK\$ time deposit rates, while narrow aggregates and bank lending have slowed significantly. Real interest rates have risen into positive territory and Hong Kong retail investors have become more cautious.

One potentially positive factor for the local bond and stock market is the planned introduction of Mandatory Provident Funds, which may have to hold a large proportion of their assets in HK\$ securities in order to actuarially match their projected future HK\$ denominated pension liabilities.

PHILIPPINES SAILING TOO CLOSE TO THE WIND

Much of the ASEAN region has been experiencing strong real growth (in the 5%-10% range) since the late 1980s. This slowed down over the 1991-92 period, but in the subsequent foreign investment boom economic activity has picked up strongly. Concerns related to this such as accelerating inflation and trade account deterioration are uppermost on local political agenda and in many portfolio investors minds. At present the Philippines is at a stage where inflation is on the brink of an upswing (if not already started one) (Chart 1) and the trade deficit (almost a perennial concern) is more likely to deteriorate from here than improve (Chart 2). These are symptoms of what remain very stimulative monetary conditions and so the expectation that they persist throughout 1996 implies the need for greater compensation to holders of Peso assets.

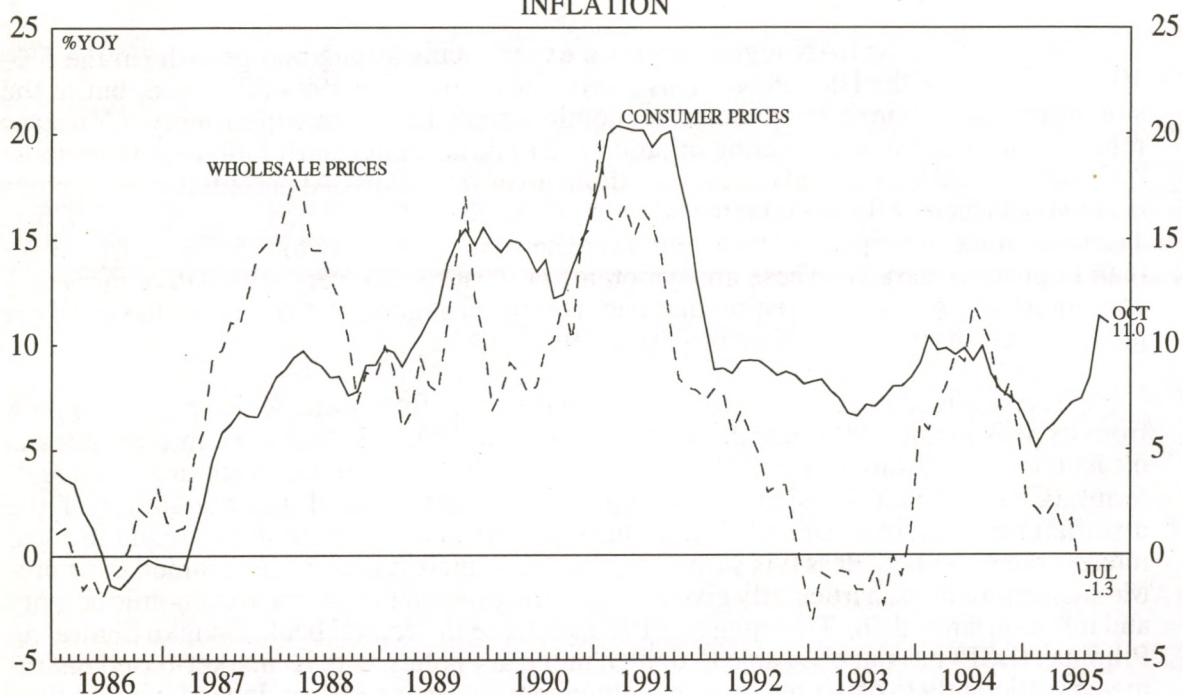
This is already beginning to be reflected in the equity market, which has fallen 24% from its peak in mid-1994 after the lengthy bull run in 1992-93. However, interest rates as measured by the 3-month T-bill rate remain close to historical lows, in nominal (and real) terms (Charts 3 and 4). Stimulative domestic conditions and a continuation of the disinflationary environment worldwide have contributed in part to these trends in local interest rates. Nonetheless it is surprising that local interest rates have resumed their pre-Mexico tremor lows, particularly given the gathering momentum in local economic activity and inflation since then. This suggests that on balance the central bank: Bangko Sentral ng Pilipinas (BSP) has not been able to tighten monetary policy with its market-based instruments sufficiently to offset the reserve requirement cuts made earlier. Indeed it is not clear that there has been much monetary tightening at all yet especially since the influx of foreign capital this summer. At some stage, possibly after a weakening in the exchange rate, the BSP will allow interest rates to rise and limit the depreciation. However given the preoccupation of the authorities to nurture economic growth, heavy monetary tightening is unlikely until we have seen more substantial and sustained rises in inflation. Consequently the ongoing monetary expansion has probably not run its course and could continue for the next few months.

In this article we review the financial liberalisation moves over the last few years and their effect on money growth. Although gauging the direction of the inflation rate is straightforward, the magnitude of its acceleration is more difficult to predict as the sensitivity of changes in money to changes in prices is declining.

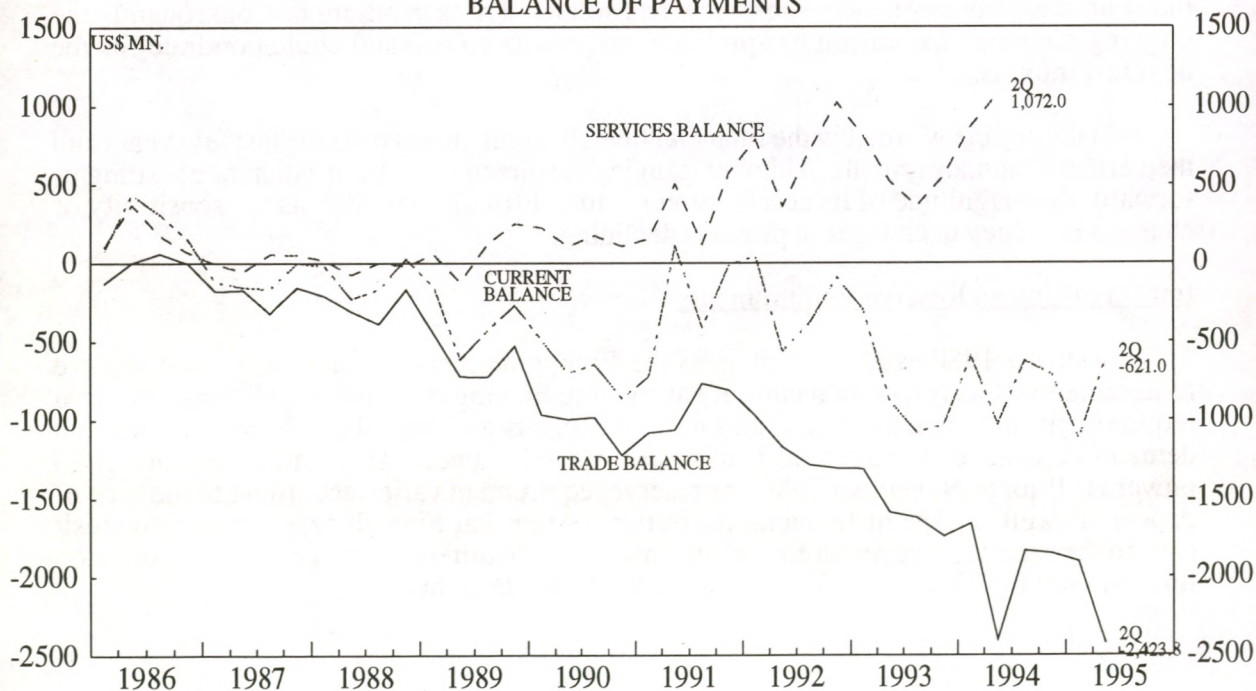
Impact of Cuts in Reserve Requirements

Over the 1980s and up until 1993 the Philippine monetary authority used reserve requirements as its favourite means of easing or tightening monetary conditions. Reserve requirements are expressed as a ratio to total deposits and deposits liabilities. Those on demand deposits of commercial banks have ranged between 16% and 25% from 1980 onwards. Prior to November 1989, the reserve requirement varied according to the type of deposit as well as type of financial institution. After that time all types of bank deposit carried the same reserve requirement ratio, although the differential reserve requirement on time and savings deposits at thrift and rural banks has been maintained.

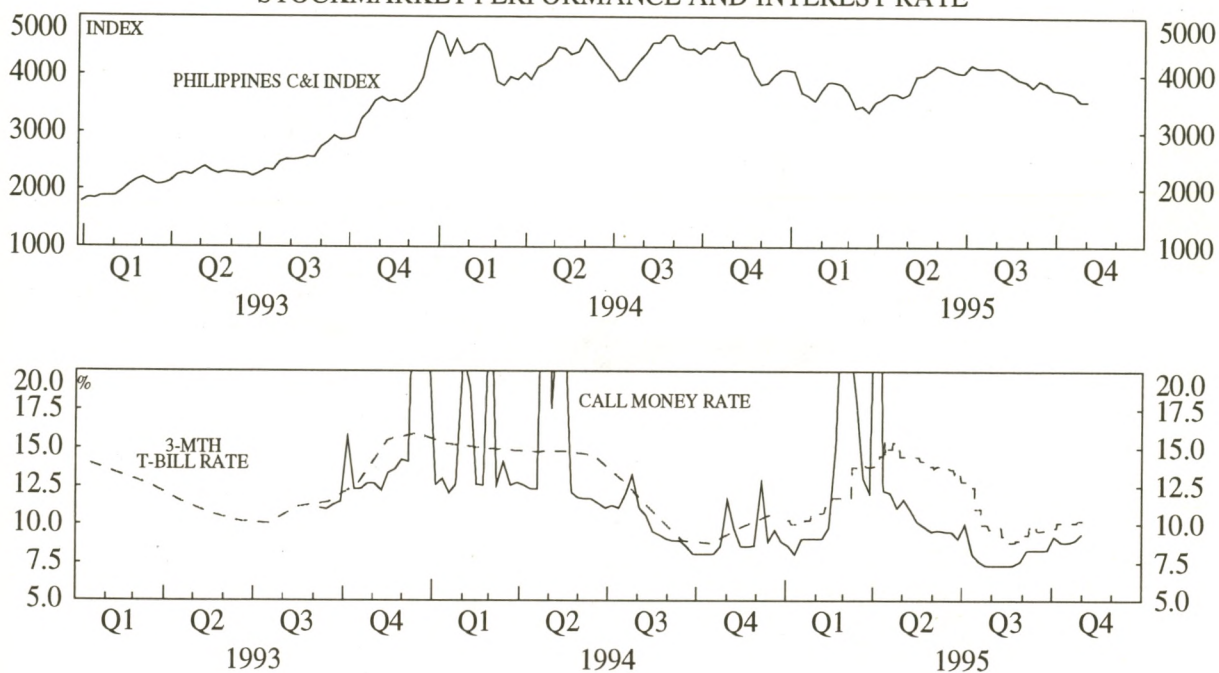
THE PHILIPPINES: CHART 1
INFLATION



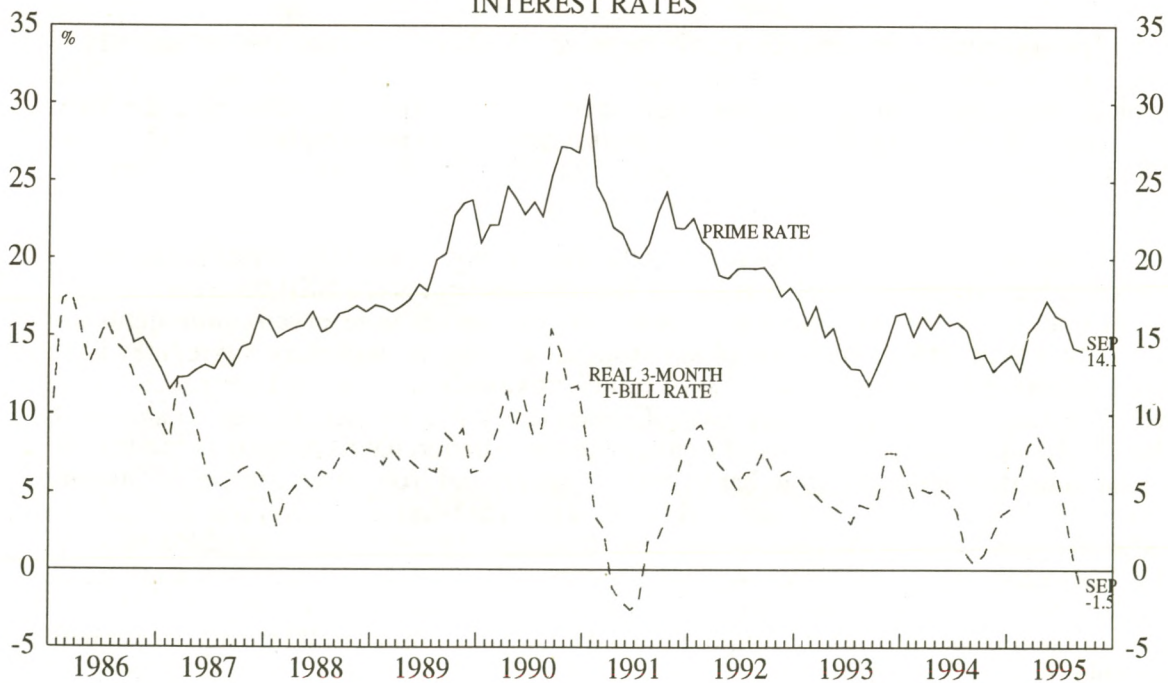
THE PHILIPPINES: CHART 2
BALANCE OF PAYMENTS



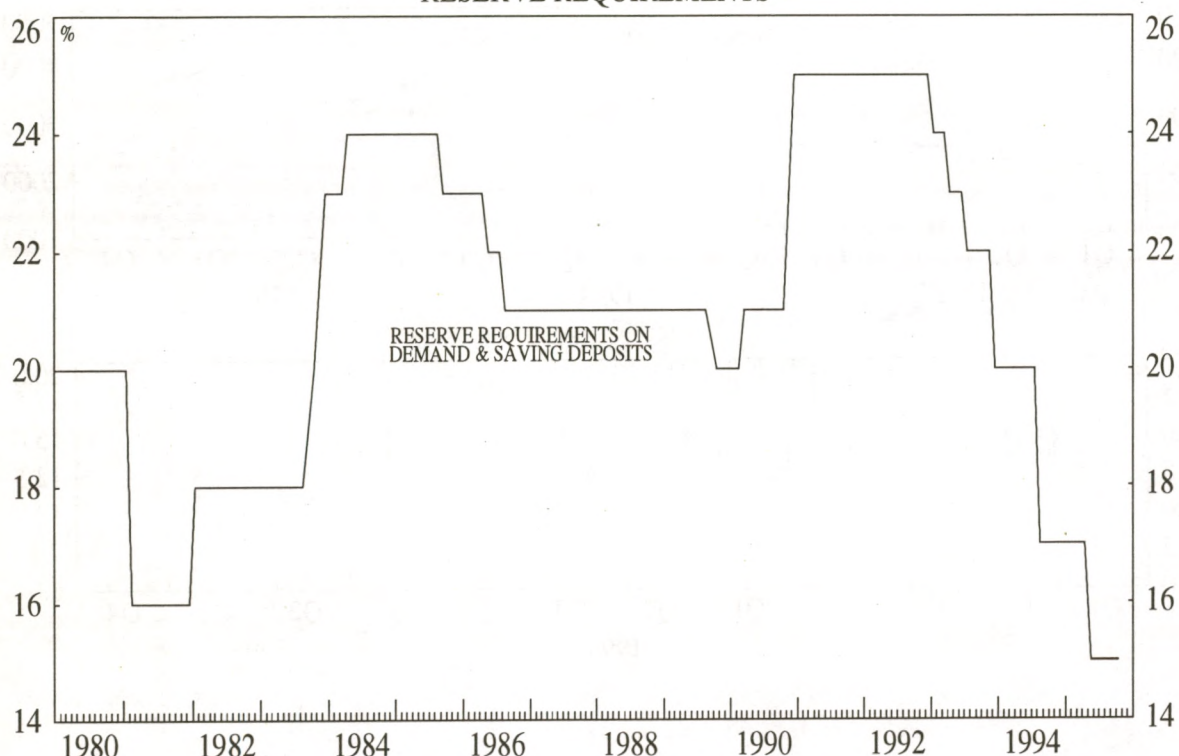
THE PHILIPPINES: CHART 3
STOCKMARKET PERFORMANCE AND INTEREST RATE



THE PHILIPPINES: CHART 4
INTEREST RATES



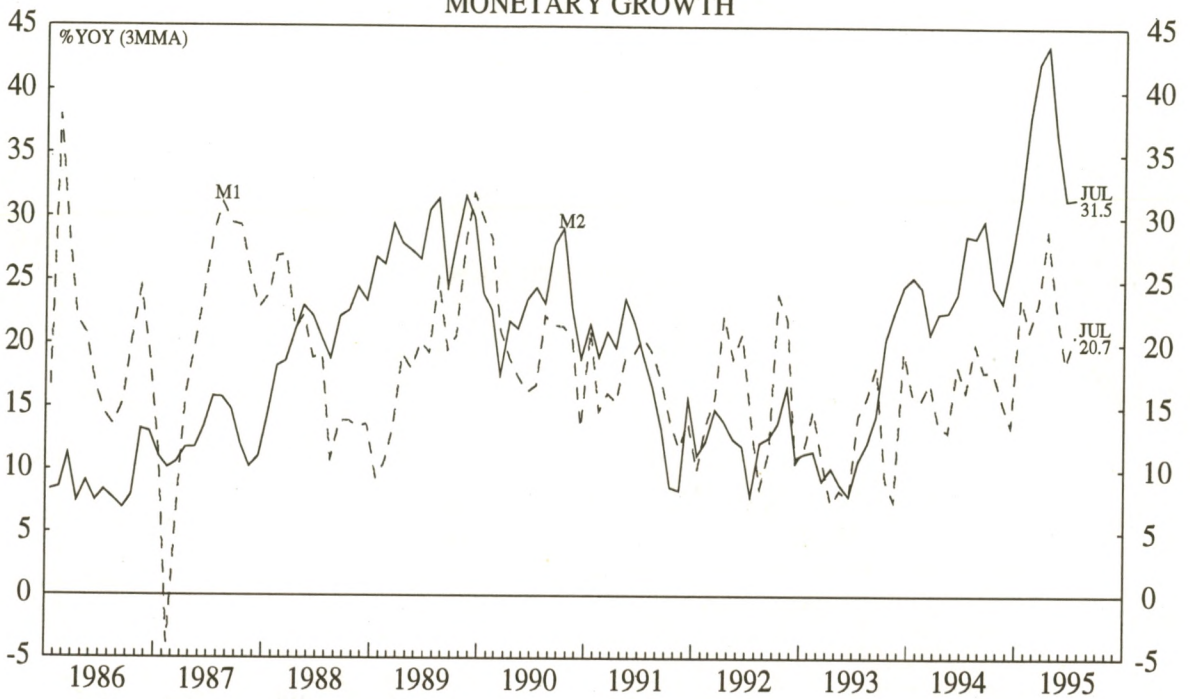
THE PHILIPPINES: CHART 5
RESERVE REQUIREMENTS



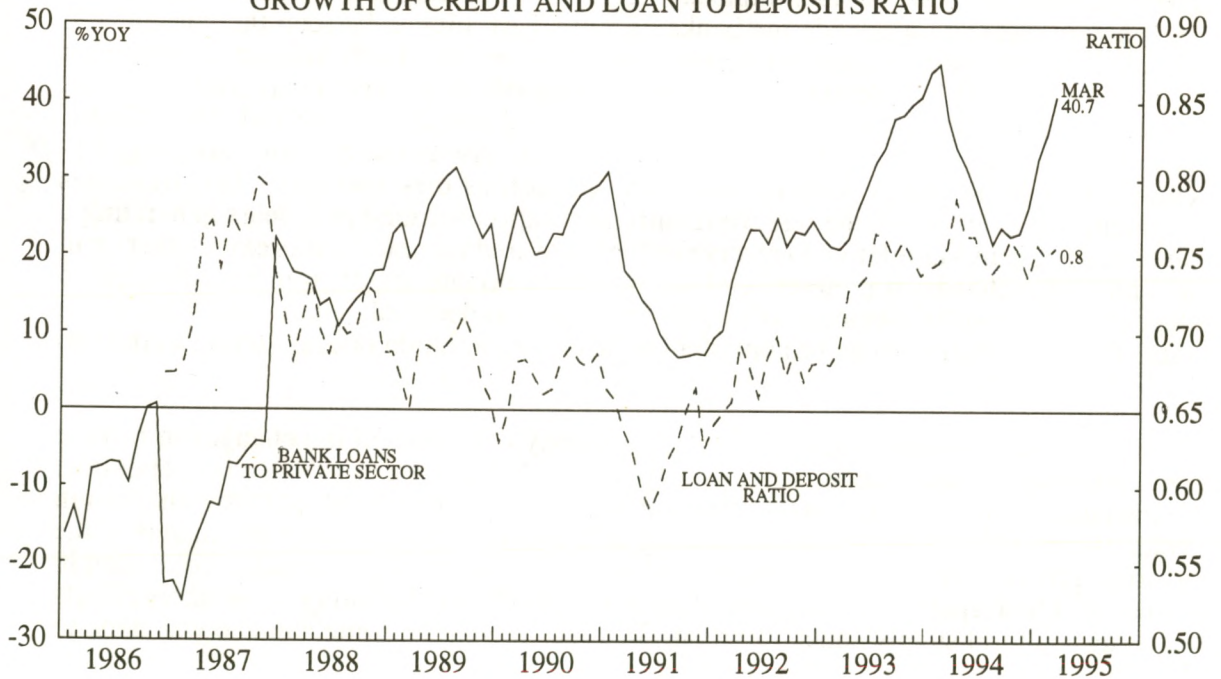
The sometimes frequent changes in (relatively high) reserve requirement ratios have encouraged banks to engage in off-balance sheet activities outside the reach of this "tax" on financial intermediation. In addition, alternative sources of funding recorded in the Trust Department Account (known as common trust funds) expanded rapidly from P32.5 bn in 1986 to P130.5 bn in 1991. They stand at P199.6 bn today although in October 1993 the central bank (BSP) imposed a 10% reserve requirement on these common trust funds.

In January 1993 the BSP has reduced the reserve requirement in a series of steps such that today they stand at 15% (Chart 5). Of the reserves held at the BSP, 55% earn a penal rate of interest of 4%. As one would expect, these changes in reserve requirements are having two main effects on the banking system. Firstly, the monetary aggregates have expanded more rapidly as the release of funds previously held at the BSP generated an overall multiple expansion of deposits. Consequently M2 has accelerated as shown in Chart 6. In addition the channels of financial intermediation have changed as funds have ceased to be diverted away from banks balance sheets and from other sources of funding not subject to reserve requirements, to the same extent as before: the incentive for banks to act as an agent between two parties has also declined. This has given an added boost to M2. The second effect is the narrowing in bank spreads as the cost of intermediating funds has declined. In addition there has been some downward pressure on deposit rates as a result of the relaxation in reserve requirements as the system finds itself initially awash with loanable funds (Charts 6 and 7).

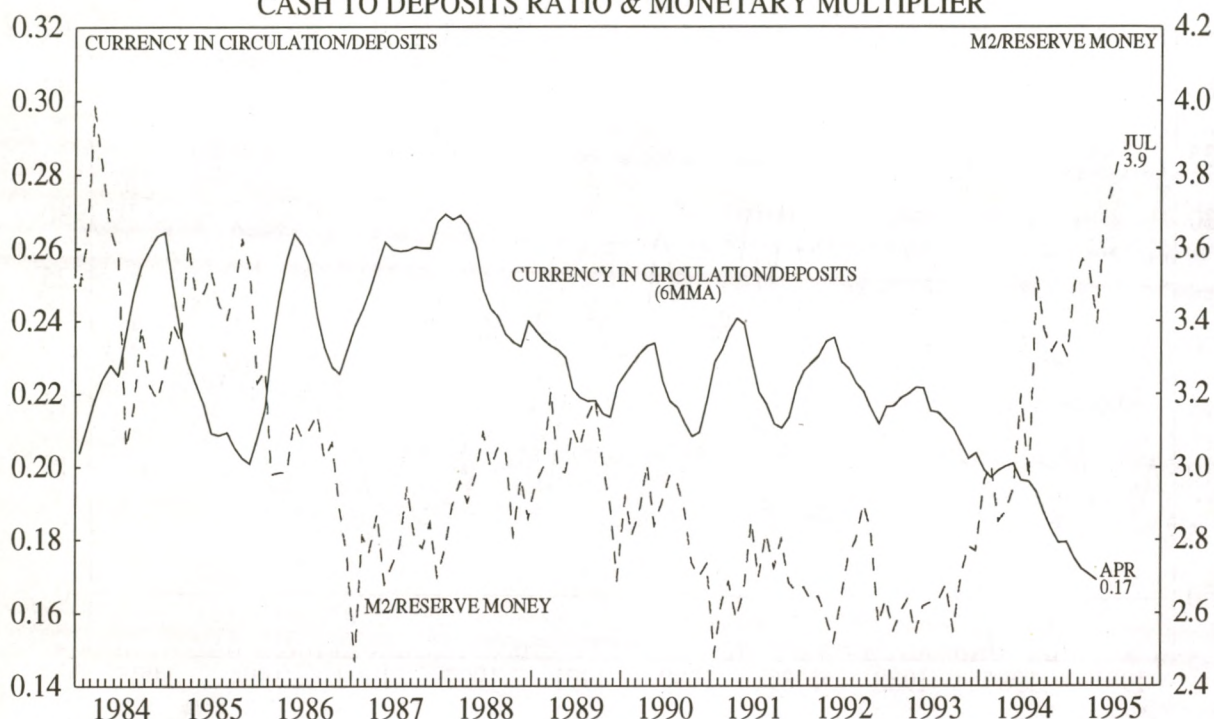
THE PHILIPPINES: CHART 6
MONETARY GROWTH



THE PHILIPPINES: CHART 7
GROWTH OF CREDIT AND LOAN TO DEPOSITS RATIO



THE PHILIPPINES: CHART 8
CASH TO DEPOSITS RATIO & MONETARY MULTIPLIER



In the Philippines (as in other countries) the relationship between changes in reserve requirements and in the broader monetary aggregates will also be affected by holdings of currency in circulation outside the banks. From Chart 8 it can be seen that currency in circulation expressed as a percentage of all deposits has been fairly volatile over the past decade -- especially in the early to mid-1980s, when public faith in financial institutions was shaken quite badly. However after fluctuating around the 22% level from 1988-92, this ratio has declined to around 16% today partly with the rise in use of cash dispensing machines (people no longer need to hold as much cash as they used to). This trend has augmented the decline in the reserve requirement ratio over the last 2 years generating a significant rise in M2 relative to reserve or high powered money. To this extent the rise in M2 reflects a change in preference of the non-bank private sector from holding cash to deposits. As a result the velocity of circulation of M2 has declined. This means that a given rate of monetary growth can be consistent with a lower inflation rate, assuming a constant real GDP growth.

Because the change in the demand for money deposits and the changes in reserve requirements have occurred simultaneously (start of 1993 to end of 1994), it is not possible to disentangle precisely the two to find out which contributes the most to the changes in velocity and M2. As a result we cannot say with much confidence what the change in the average growth in M2 velocity will be and thereby gauge an approximate acceleration in inflation. Quite apart from this, there is the added problem of factoring in the likely effects of an agricultural supply shock this year. In a recent typhoon some damage was done to infrastructure and rice crops in key rice growing areas.

To some degree these monetary trends are reminiscent of those in Indonesia in 1988 when reserve requirements were cut in one stroke from 15% to 2%. The resulting easy money conditions together with a substantial rise in the number of (undercapitalised) banks led to an unsustainable bubble in financial assets which ended in disaster 2-3 years later after interest rates began to rise. The central bank then had the lengthy task of supplying enough credit to ailing institutions to enable them to repair their balance sheets while monitoring the concentration of banks assets to various sectors more closely (AMM Vols 17 No 3 and 19 No. 4).

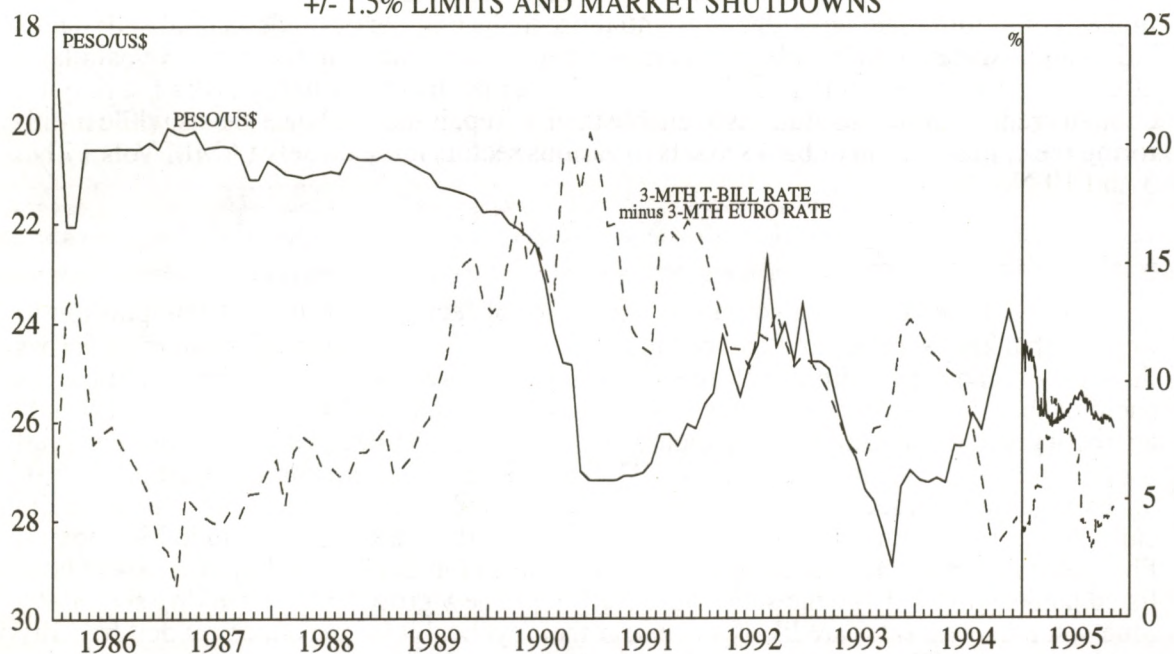
Financial Liberalisation

In 1994 the BSP has also opened the financial sector to let in more competition to improve banking services and reduce the spreads between lending and deposit rates across the banking industry. Initially 10 foreign banks have been permitted to open 6 branches each: of these 7 have entered so far. Another positive aspect of this policy is the encouragement given to banks to build up their capital base. The BSP raised the minimum capital for commercial banks to P1.25 bn from P750 m in an effort to encourage consolidation of the expanding bank sector. Some of the local major banks have already raised funds on the capital market to fund their fight for a share of the market. Examples include Metrobank, Philippines Commercial and International Bank and Union Bank of Philippines. Some non-listed banks will likely go the same way. Such rapid new growth in the banking sector at a time when interest rates are likely to be near their cyclical lows introduces added fragility into the system. The smaller newer banks will tend to take on board more risky ventures since they may aim to expand their market share to a larger degree than some of their larger and more well established competitors. These competitors will have greater knowledge of their clients and therefore a more accurate assessment of the riskiness of their assets. If the desire to gain market share wins over the need to maintain a balanced loan portfolio and results in a significant concentration of loans to one sector or entity, then the banking system could be in for a tough consolidation period when interest rates eventually rise.

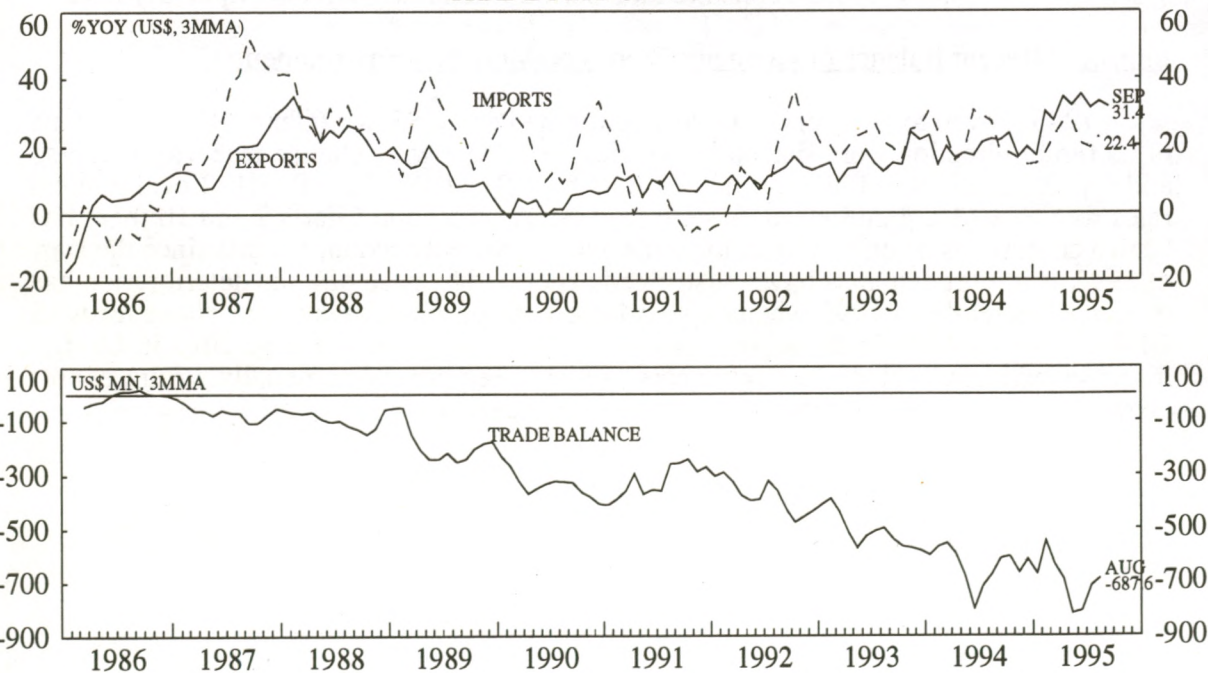
Impact of Recent Balance of Payments Trends on Monetary Environment

1993 proved to be a very volatile year for the Peso/US\$ rate (Chart 9): expectations of its future direction were shaped by worries about foreign exchange reserve rundowns and calls by a number of high profile senators for a Peso/US\$ rate of 35:1. Local interest rates rose to a 12% premium to those in the US. As shown in Charts 2 and 10 there has been a continuous deterioration in the trade and the current account deficits since the start of 1992 as import demands have outstripped exports. The pace of trade deterioration has moderated slightly in 1995 when exports have been particularly strong. However with GNP growth of 4.9% in the second quarter of 1995 and given the large rises in foreign direct investment over the last few years, it would require phenomenally strong export growth to bring about an improvement in the trade deficit.

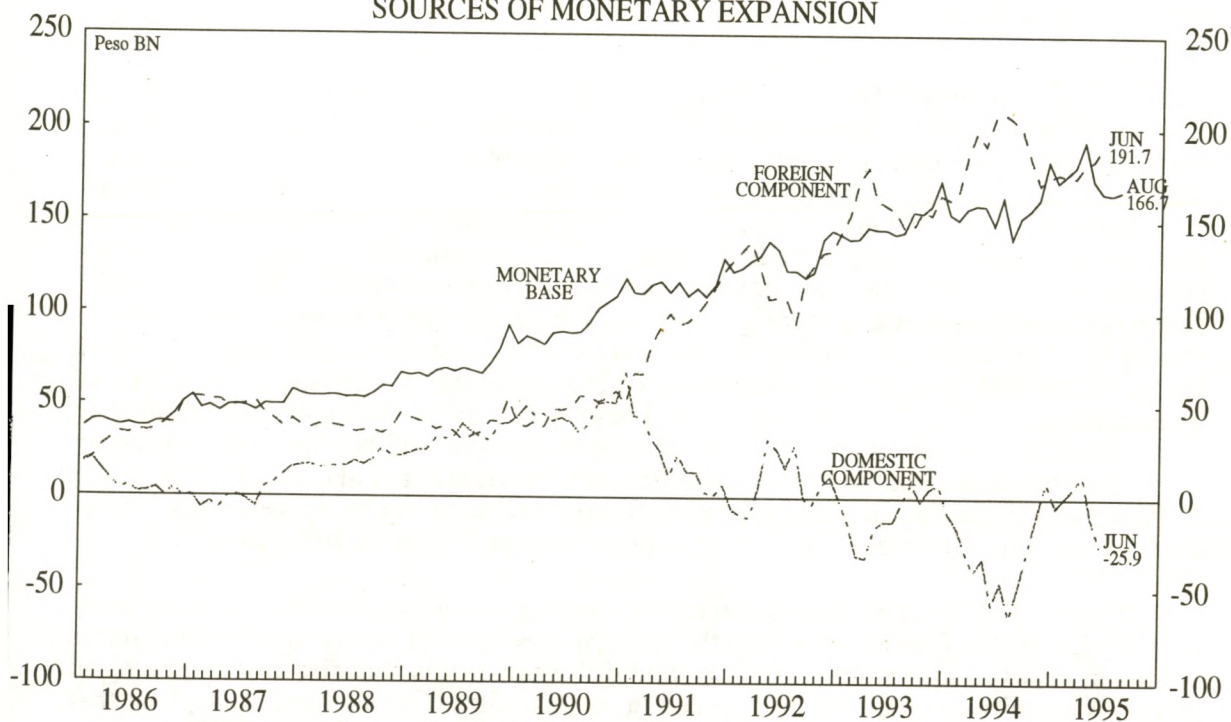
THE PHILIPPINES : CHART 9
+/- 1.5% LIMITS AND MARKET SHUTDOWNS



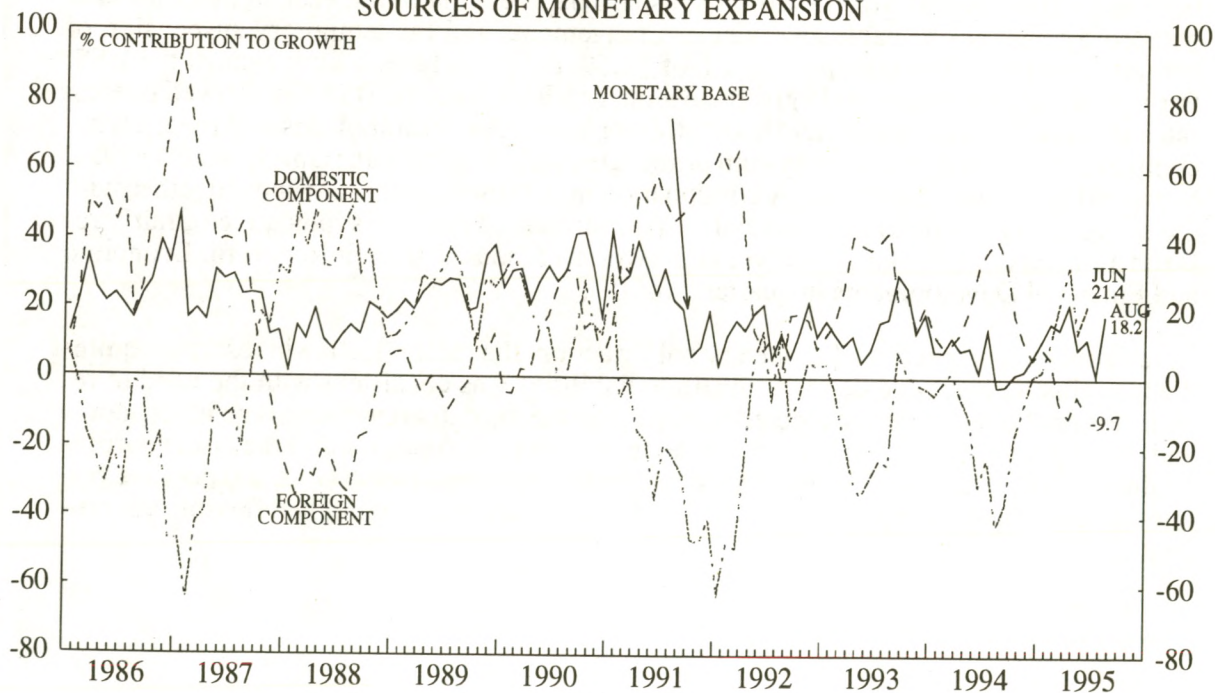
THE PHILIPPINES: CHART 10
TRADE PERFORMANCE



THE PHILIPPINES: CHART 11
SOURCES OF MONETARY EXPANSION



THE PHILIPPINES: CHART 12
SOURCES OF MONETARY EXPANSION



In 1994 the Peso/US\$ saw a change in fortunes as the impact of inward direct and portfolio investment swamped that of the current account. As has been the case in other parts of ASEAN the monetary authorities were caught in a dilemma as they sought to cap the appreciation in their currency yet at the same time try to prevent the monetary expansion that this entailed (Charts 11 and 12). For the Philippines this was a new problem not encountered before. Although the BSP conducted heavy sterilised foreign exchange intervention, local interest rates came down to new lows (Charts 3, 4 and 9). The main sterilisation instrument used was sales of government T-bills. However, other measures such as raising the deposits of government agencies at the central bank also played a role. As in Malaysia, the BSP in the Philippines introduced various hindrances to the influx of capital in an attempt to stabilise the exchange rate. These included: reserve requirements on credit from abroad and on foreign currency denominated deposits, withholding taxes on certain foreign exchange receipts and prior authorisation for certain external loans. For the whole of 1994 the BSP purchased \$2.9 bn from the foreign exchange market representing 39% of the total volume of transactions: a sharp contrast to the net sales of \$51.9 m in 1993.

Naturally the foreign component contributed significantly to reserve money growth in 1994 (Chart 12). However the growth in reserve money itself decelerated with the series of cuts in reserve requirements and it is doubtful whether this signifies any tightening in monetary conditions. Indeed the declines in interest rates (Charts 3 and 9) suggest that there had been a plentiful supply of deposits to the banking system during 1994.

This situation changed in the first few months of 1995 with the Mexican crisis and ensuing financial market scrutiny of the Philippines trade deficit and its foreign debt servicing capabilities (AMM Vol. 19 No. 2). A sharp depreciation of the Peso at that time was resisted by changes to bank supervision arrangements and the temporary suspension of computerised Peso trading upon breach of $\pm 1.5\%$ daily fluctuation limit against the US\$. Perhaps somewhat surprisingly given the monetary backdrop, the BSP has allowed interest rates to come down to their pre-Mexico tremor lows. As a result of this and the growing competition within the banking system prime rates will likely remain stable having declined to around 14% (in September). A continuation in the low real cost of funds together with the ongoing expansion in the financial system (discussed earlier) is indicative of fairly relaxed monetary conditions. However in the words of the BSP in their Report for Economic and Financial Developments in quarter 2 (p. 19):

"..... From the perspective of monetary policy action, the recent decline in reserve requirement against deposit and deposit substitute liabilities was consistent with the need to reduce nominal interest rates expected to impact on the third quarter, encourage investments and attain higher economic growth. Adequate growth in liquidity and the fiscal surplus attained by the National Government helped bring about relatively stable and positive real interest rates during the period. On the whole, monetary policy remained flexible yet prudent....."

SUMMARY AND CONCLUSIONS: The reduction in reserve requirement ratios are contributing to an easing in monetary conditions: bank credit and M2 growth are growing vigorously. Borrowing conditions also remain favourable as the BSP has allowed local interest rates to decline to their pre-Mexico lows. Put another way, the authorities have been unwilling to permit the Peso/US\$ to appreciate in line with the resumption in the influx of foreign capital over the summer and as a result T-bill yields and deposit rates have been driven down again. The growing degree of competition in the finance sector could entail a rise in the asset concentration of some banks, however the BSP has raised minimum capital requirements for new and existing entrants perhaps in anticipation of this. The current easy monetary conditions point towards a continuation in the strength in economic activity, and will exacerbate its symptoms: faster inflation and further deterioration in the trade figures.

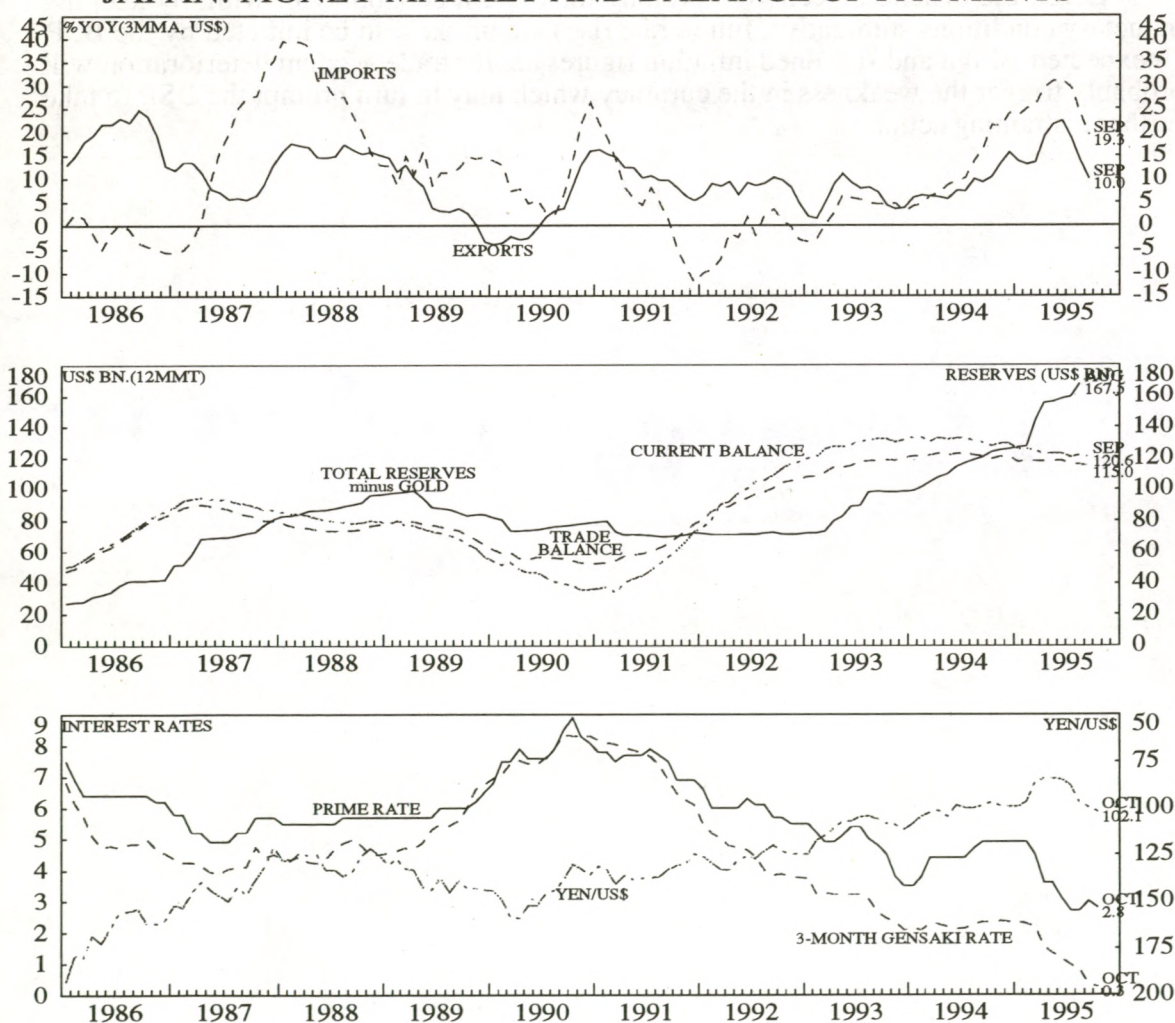
The equity market has already corrected from its high in mid-1994. However, given the likely upswing in local interest rates ahead, progress in the stockmarket will get increasingly difficult. This could dampen the currently optimistic expectations that are held by financial corporations who intend to engage in capital raising in the months ahead.

Given the official objective to prolong the current economic upswing by keeping monetary conditions stimulative, future rate rises are unlikely to be initiated by the BSP. Unexpectedly high and sustained inflation figures and/or trade account deterioration will probably trigger the weakness in the currency which may in turn prompt the BSP to take further restraining action.

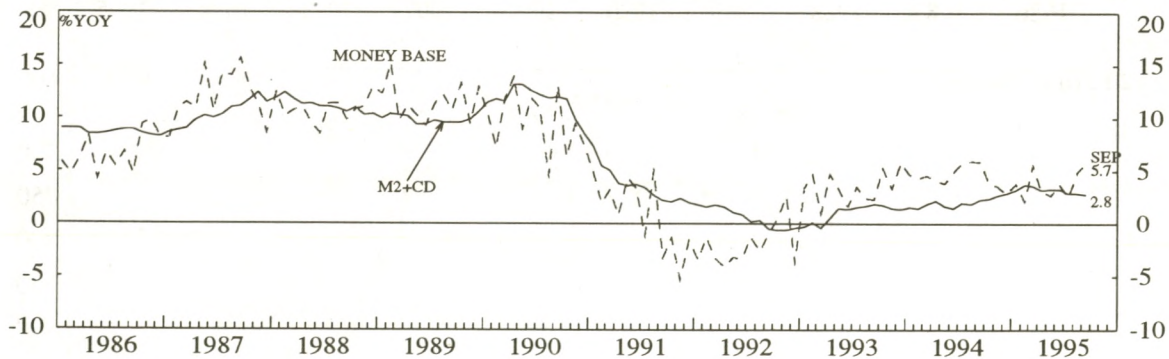
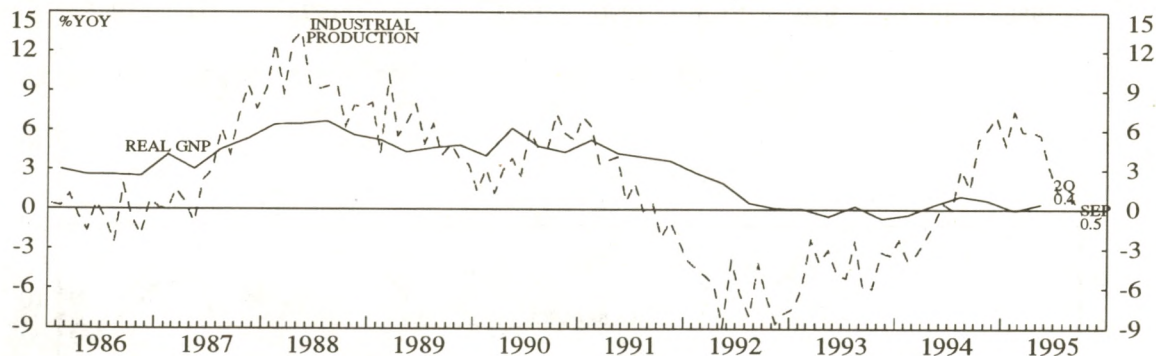
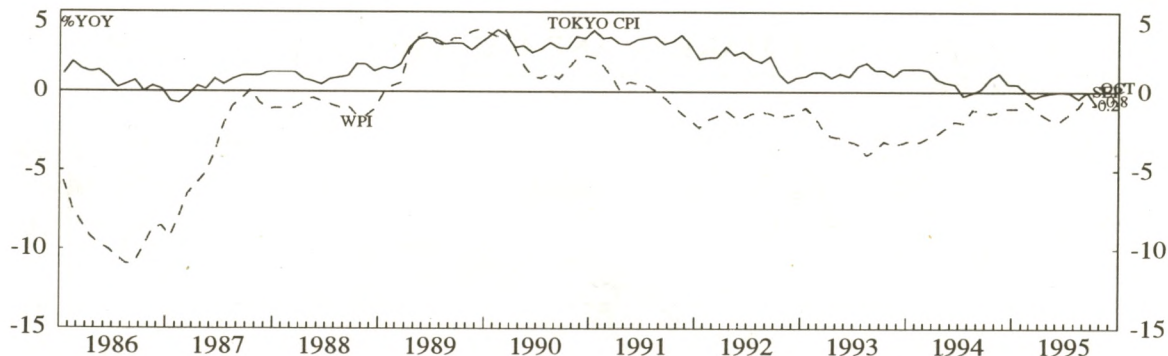
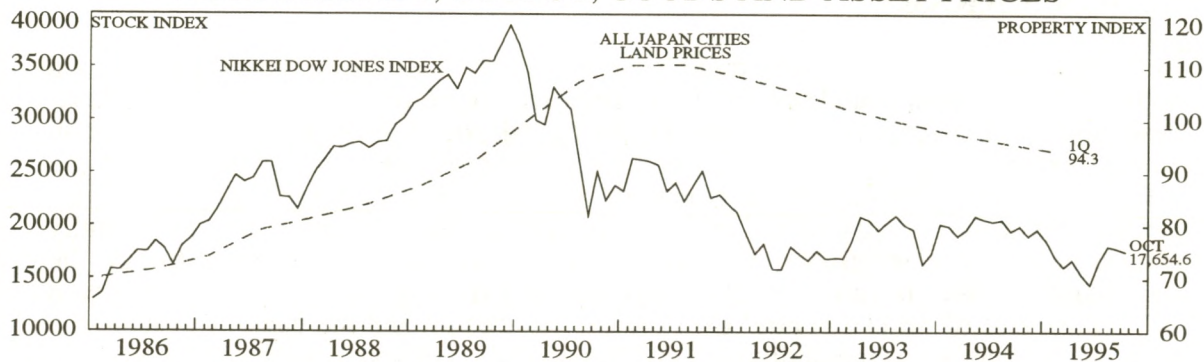
JAPAN: A FEW POSITIVE SIGNS, BUT BROAD MONEY GROWTH IS STILL TOO SLOW

The pressures on the balance of payments finally appear to be turning around, as reflected in the weakening of the yen and the stabilisation of official foreign exchange reserves. Record low interest rates have lowered banks' cost of funds, but have also greatly reduced the incentive to hold yen time deposits (especially given the concerns about the banking system). This has prompted a growing interest in foreign assets and a switch from maturing bank time deposits into postal savings, demand deposits and cash currency (hence the acceleration in M1 and monetary base growth). However, the continued sluggish growth of M2+CDs will keep nominal GDP growth negative this year and below 2% in 1996, and will continue to constrain corporate earnings growth. The sluggish money supply growth and the excess of domestic prices over world prices (even with the current weaker yen) continues to exert deflationary pressure on goods and asset prices. The current inventory correction will keep real GDP growth close to zero for 1995 and the first quarter of 1996, but a modest recovery in real growth (to around 1% per annum) should be possible later in 1996.

JAPAN: MONEY MARKET AND BALANCE OF PAYMENTS



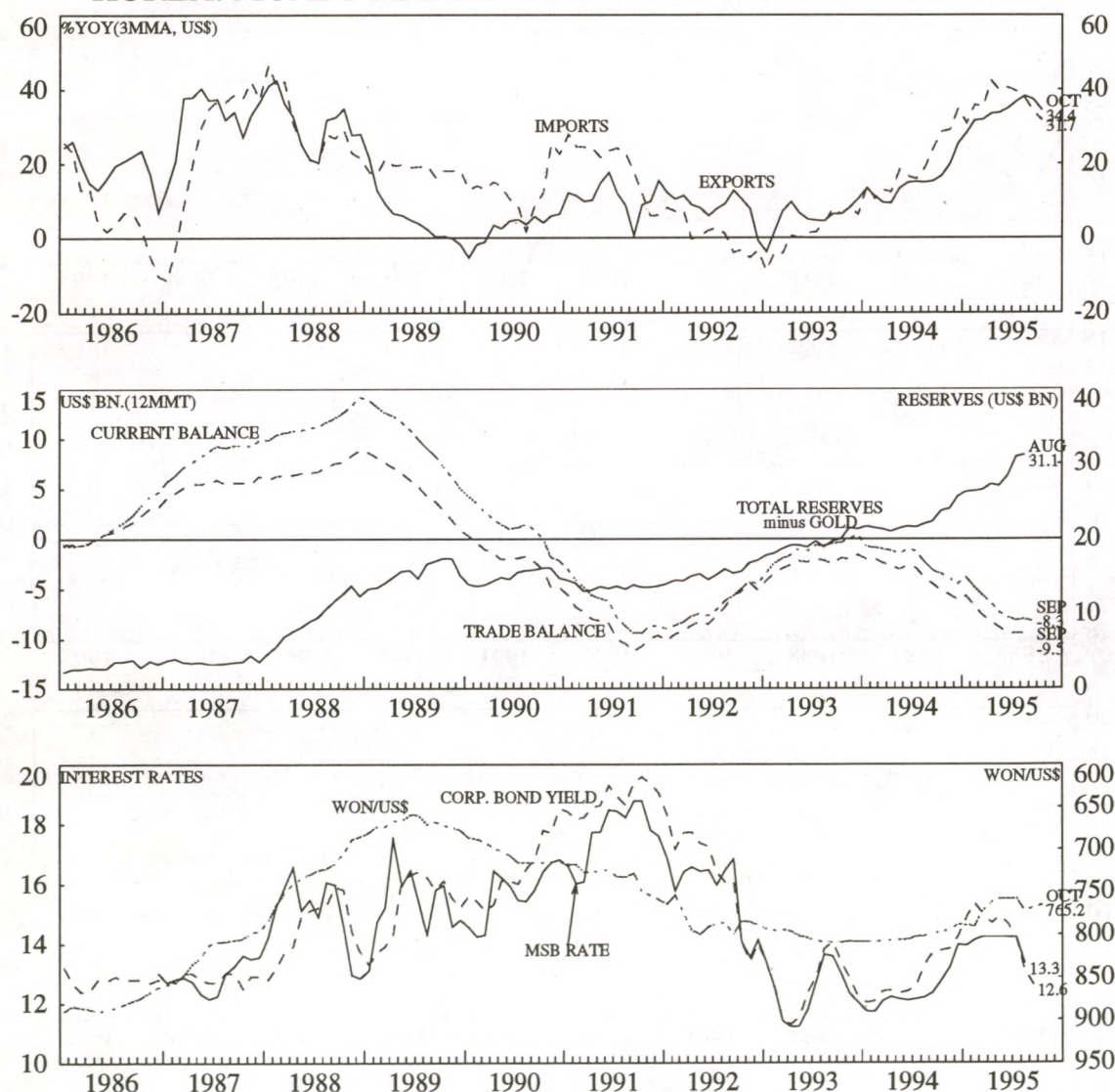
JAPAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



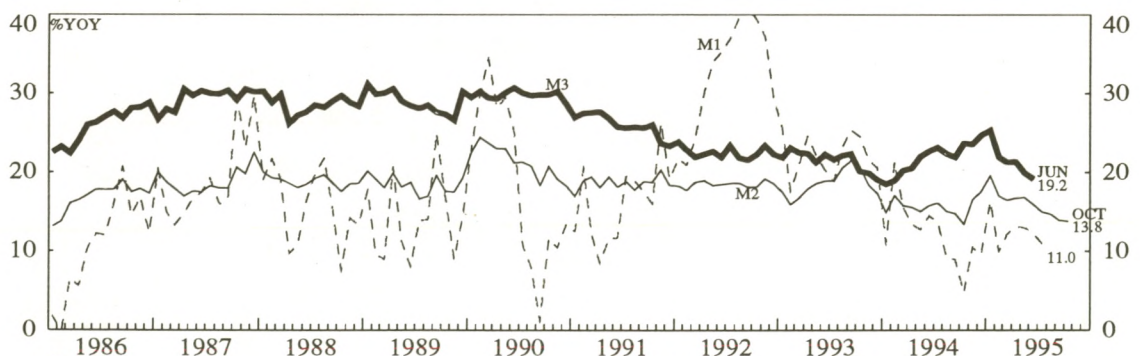
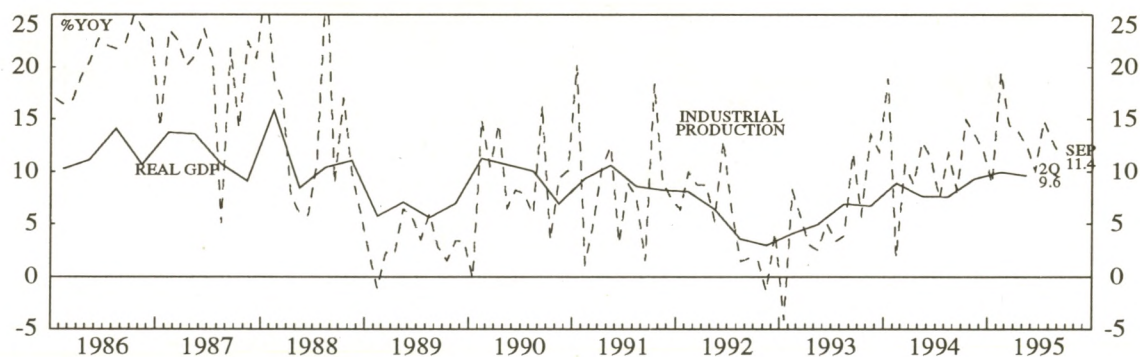
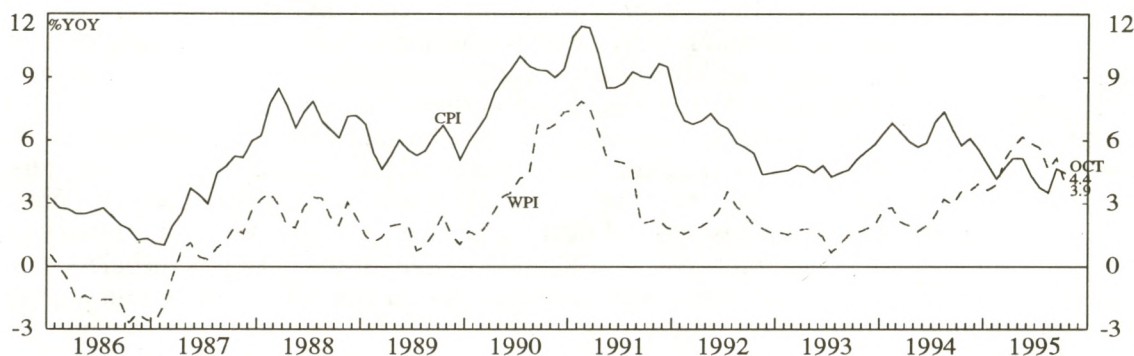
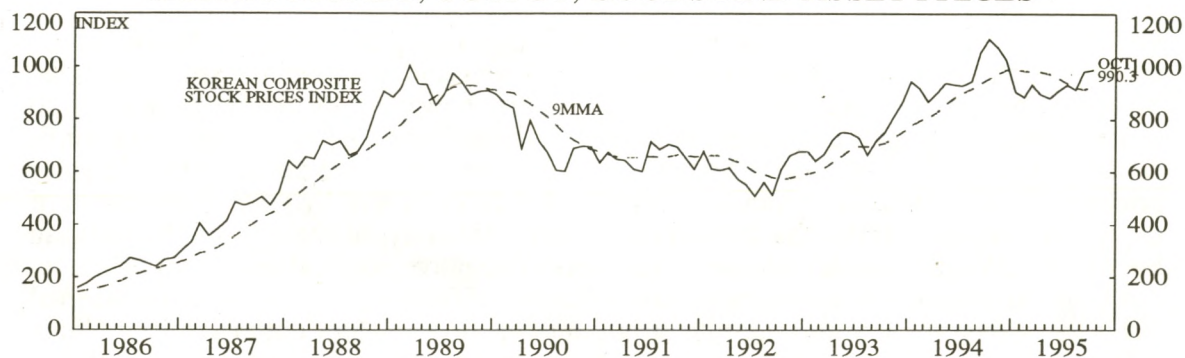
KOREA: IMPROVING TRADE BALANCE COULD BOOST STOCK MARKET

In the first half of 1995, Korea's trade balance benefitted less from the strong yen than conventional wisdom would suggest, as the negative price effect of more expensive Japanese imports (often export-sector related capital goods) outweighed the positive effect on Korea's export competitiveness in the short run. Conversely, the positive price effect of a weaker yen may in the short run outweigh the negative effect of diminished export competitiveness on the overall trade balance. As high interest rates earlier this year successfully slowed down monetary growth and helped moderate the earlier investment frenzy, the trade balance (which has already stabilised) could well improve further. Historically, given the high degree of official control over the capital account and the banking system, the trade balance has been a major driving force behind both economic growth and liquidity for the stockmarket.

KOREA: MONEY MARKET AND BALANCE OF PAYMENTS



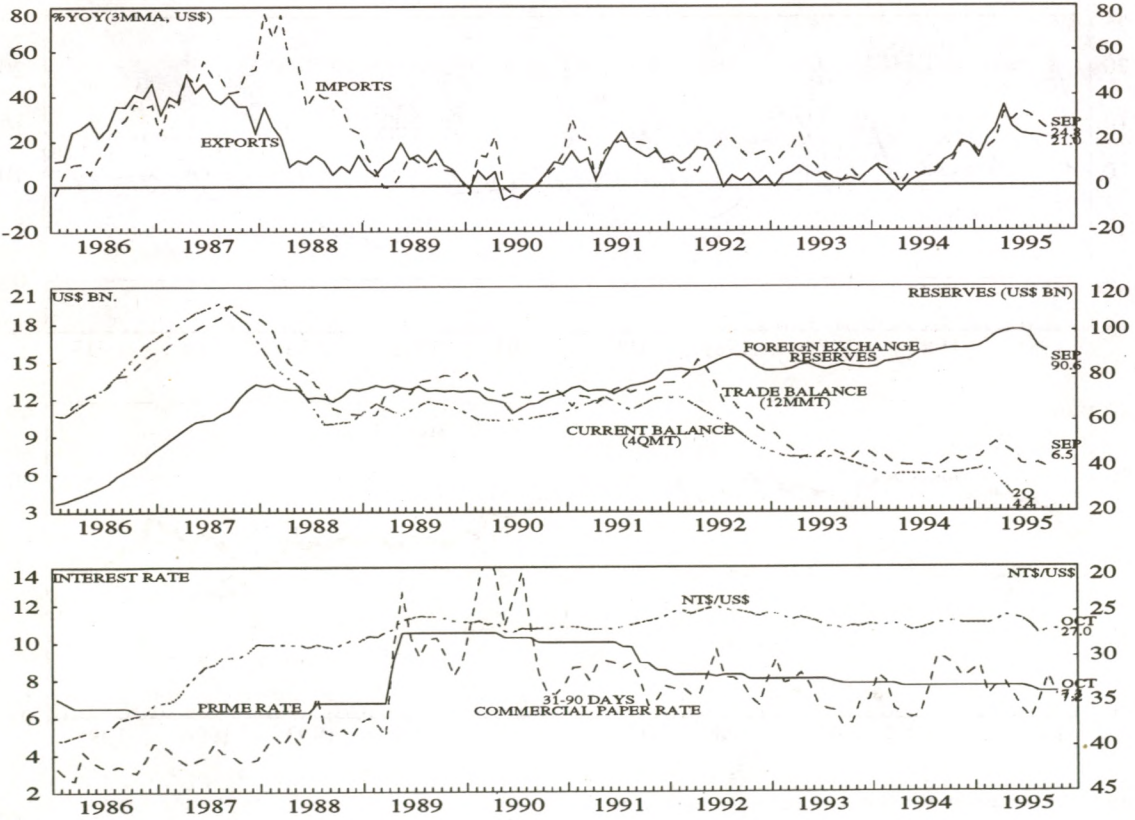
KOREA: MONEY, OUTPUT, GOODS AND ASSET PRICES



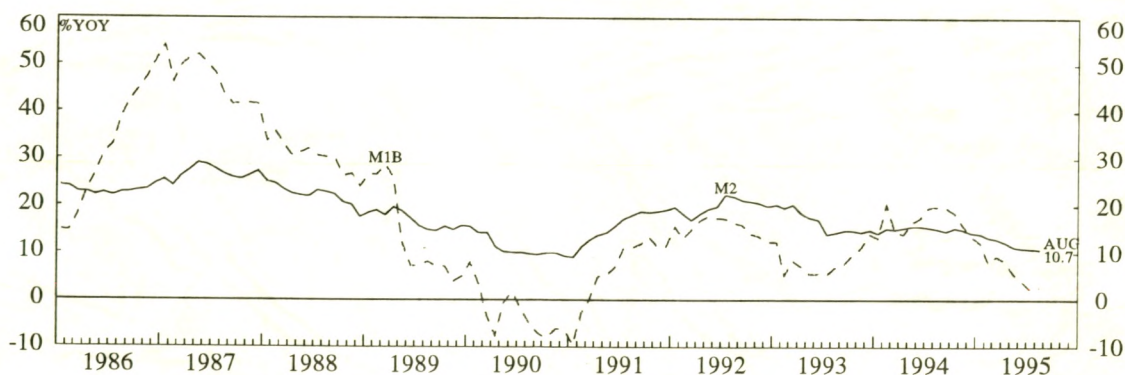
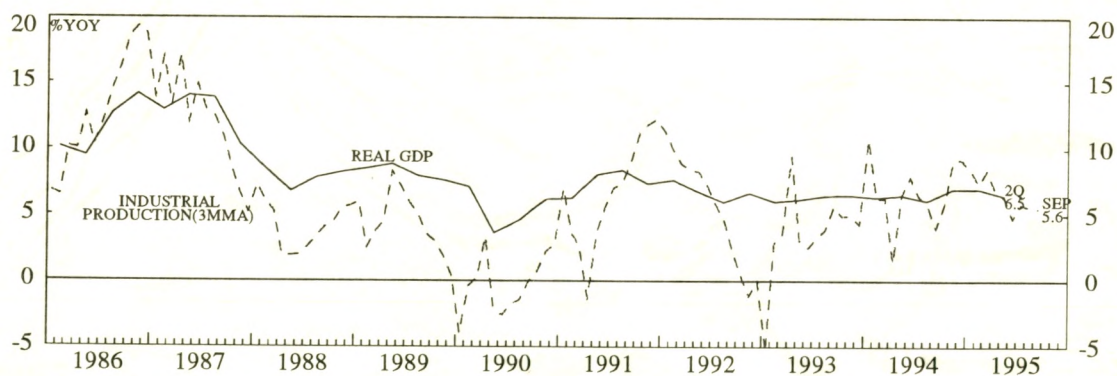
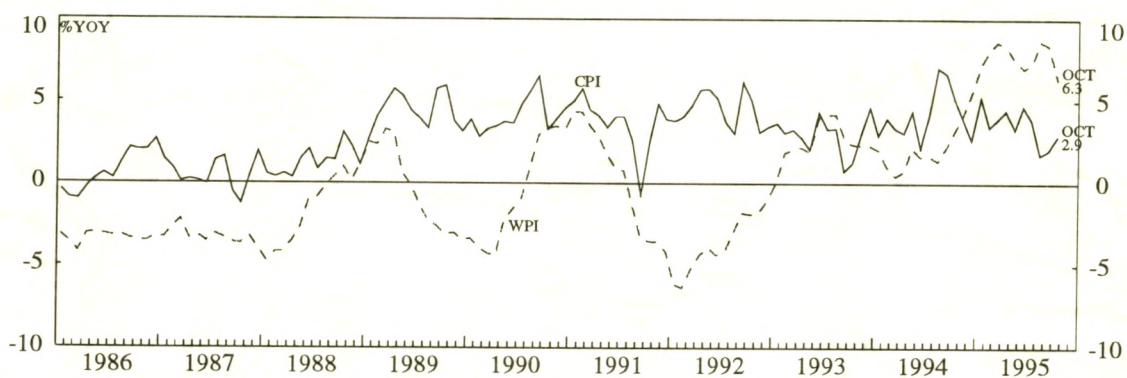
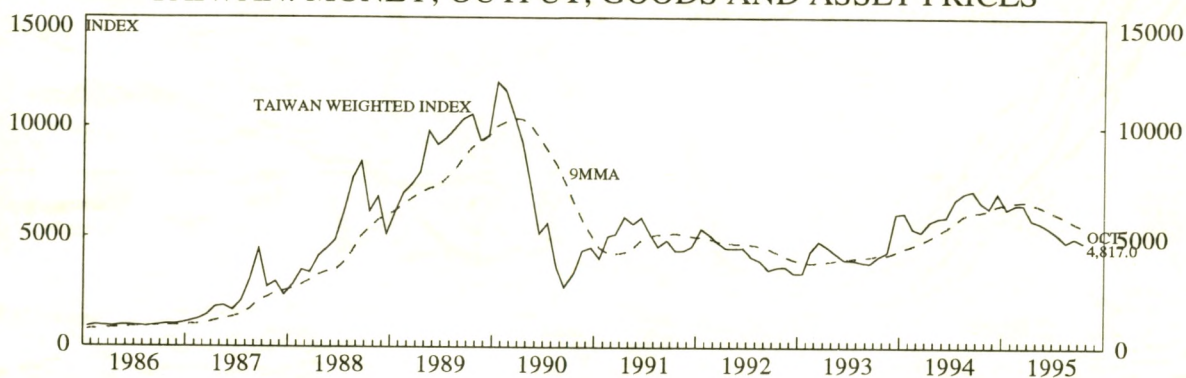
TAIWAN: WOOING BACK THE CONSUMER

We have previously highlighted the long-term challenges facing the Taiwan economy; mainly the migration of its export base to cheaper destinations and the potential need for closer economic ties with China. In the immediate future, however, the challenge remains to restore some measure of consumer confidence and stability to the NT\$. Consumer confidence in Taiwan has been badly dented by sharp correction of the property bubble since prices peaked in 1990. The gloom has been further compounded by poor performance of the equity markets, a fragile banking system (with problems conceptually similar to Japan but of a smaller magnitude), and periodic bouts of negative political sentiment. Most recently, political factors also triggered a sharp outflow of foreign currency, which weakened the NT\$ against the US unit, despite strong intervention by the Central Bank of China (CBC). M2-type money supply growth has fallen in sympathy with currency outflows to the bottom of the CBC's 10-15% target growth range. The CBC is thus faced with the dilemma of contemplating an easing of monetary conditions, against the backdrop of poor demand for loans, and the possibility of further capital outflows as domestic interest rates fall close to (or below) those in the US. Recent injections of liquidity do not appear to have supplied any support to the beleaguered stock market. Further liquidity boosts will probably bide time within money markets until legislature and presidential elections are completed by March 1996. In the meantime the NT\$ is likely to remain under downward pressure as the US dollar strengthens and political uncertainty prevails. With an armoury of US\$91 bn in foreign currency reserves, CBC's smoothing of the currency turbulence at the margin will not be a constraint, while depreciation of the NT\$/US\$ should supply welcome support for the export sector.

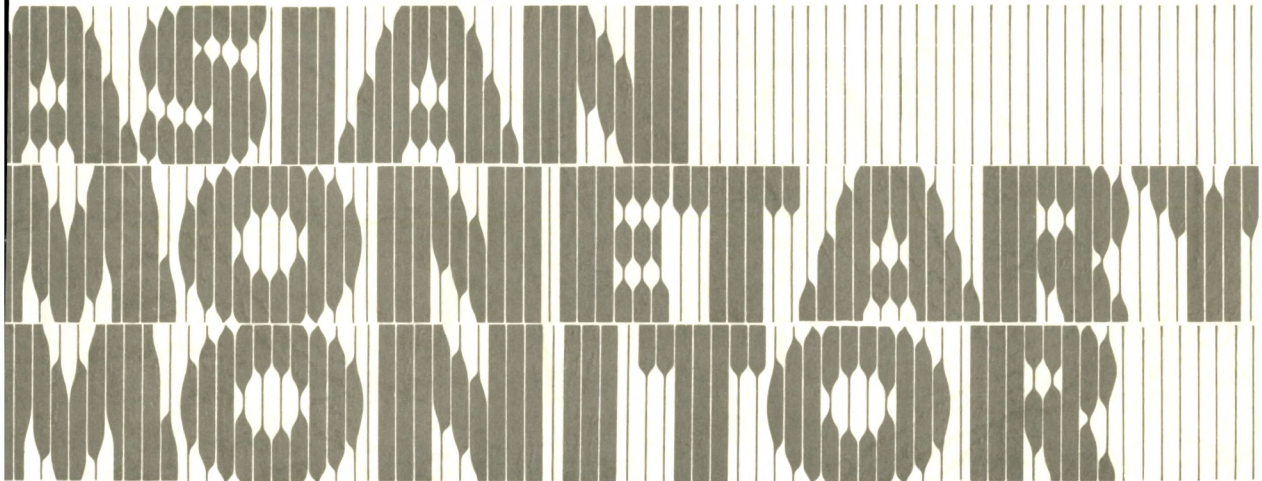
TAIWAN: MONEY MARKET AND BALANCE OF PAYMENTS



TAIWAN: MONEY, OUTPUT, GOODS AND ASSET PRICES







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AUSTRALIA FURTHER MONETARY RESTRAINT REQUIRED

Introduction

As with the US, the current economic upswing in Australia continues to be more subdued than the previous one (which lasted from 1987 to 1990). The current weakness in some of the economic indicators together with the proximity of the elections mean that monetary tightening in the near future is unlikely. This commonly held view is reflected in the bank bill futures market which builds in a 50 basis point tightening by March 1997. At present, market sentiment leans more towards an easing of monetary policy in the near term. This environment is supported by the recent rally in longer dated government bonds whose yields appear to have (perhaps blindly) followed their counterparts in the US on the basis that the Australian economy is slowing and that lower inflation is just round the corner.

This is unlikely to be the case as the overall stance of monetary policy remains mildly stimulative. Consequently the economy is likely to remain buoyant and inflation will retain its upward momentum next year. Against this economic background, long bond yields, which have moved in step with those in the US over the last year, could begin to build in more of a premium in the months ahead. In addition, at some stage in 1996 (after the election) the RBA will likely consider the economy to be showing sufficient resilience, and the higher inflation to be persistent enough, to warrant further monetary tightening. At this point we can expect the yield curve to begin to flatten (and perhaps invert) with the structure of interest rates shifting upwards. Until this time the equity market could continue to see limited gains although the window of a relatively relaxed monetary environment and declining long bond yields is closing.

In the first part of this article we assess the monetary stance as given by a broad measure of monetary growth (broad money plus bank bills) and consider the likely lag between the current upswing in broad money plus bank bills and CPI inflation. A brief review of credit growth and expenditures across the economy reveals a mixed picture, although the structure of interest rates as well as the level of real interest rates indicates a fairly relaxed monetary environment. This article ends with an outlook for the current account and the A\$. A change in the fortunes of exports may mean that the worst of the current account deterioration has already been absorbed through A\$/US\$ weakness. However, import demand will likely strengthen in line with the economy in the first part of 1996 and so further current account improvements are likely to be minor.

Monetary and Income Growth

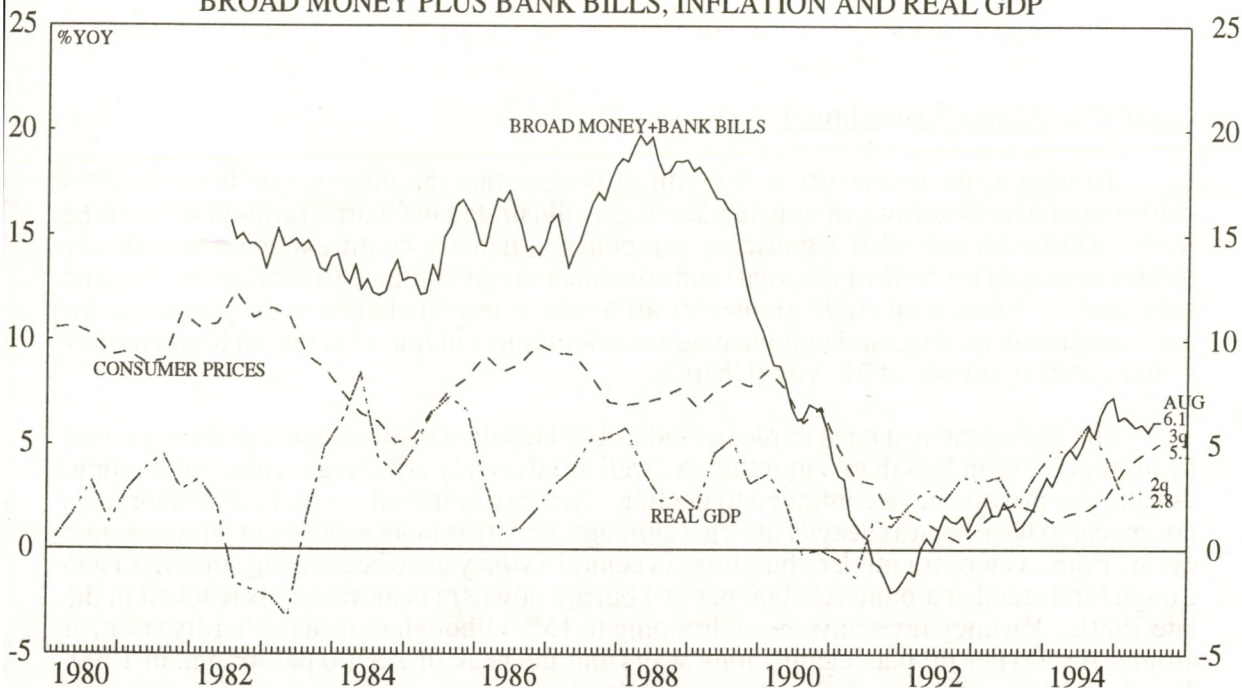
An examination of previous trends in broad money plus bank bills, income and prices, reveals the current expansion in money and credit to be longer and more subdued than has been the case in the past. While real GDP growth reacts relatively quickly to changes in broad money plus bank bills growth, it is clear that accelerations in CPI inflation can continue well into a period of monetary rectitude. Consequently even in the unlikely event that the RBA raise interest rates further within the next couple of months, the current upswing in the CPI would continue well into 1996.

In the years leading up to 1984, credit conditions were stimulative and there had been significant liberalisation in credit directives (and in various interest rate ceilings). The ensuing monetary expansion in 1984 led to an acceleration in real GDP growth and CPI inflation followed soon afterwards. In the monetary tightening that followed -- in 1985-86 -- real GDP decelerated abruptly, however, the rate of CPI inflation continued to accelerate reaching a climax towards the end of 1986 (Chart 1). The next general expansion in money lasted from 1987-89. During this time real GDP growth recovered and initially the rate of CPI inflation decelerated as a lagged result of the earlier monetary squeeze. As the monetary conditions remained stimulative through 1989 so real GDP growth remained robust that year. In addition, instead of the rate of CPI inflation declining further, it turned around and reaccelerated to a peak of 8.6% in early 1990. Once again, as in 1985, the rate of CPI inflation continued to accelerate through the initial period of monetary austerity.

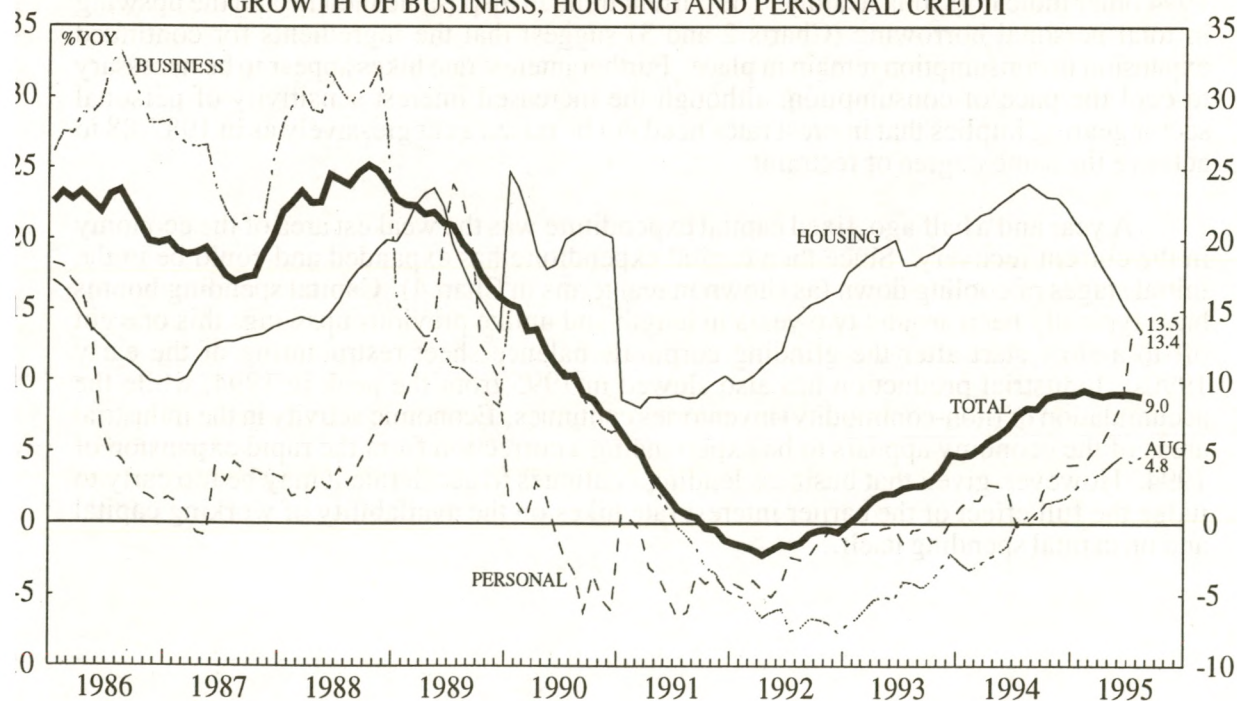
As can be seen from Chart 1, changes in the CPI inflation rate have tended to follow those in broad money plus bank bills growth with a lag of one to two years. In addition, it has required a deceleration of varying magnitudes in broader monetary growth to bring about a slowing in inflation. As there has not been any evidence of this yet it would be premature to call a slowing in inflation next year (as some commentators are suggesting).

The current upswing in broad money plus bank bills started from an historically low base in 1991 as did CPI inflation, which reached its trough in 1992. When viewed in real terms, the growth of broad money plus bank bills has been on a general uptrend (from the negative rates of growth in 1990-91), interspersed with temporary downturns as the rate of CPI inflation has accelerated. Despite the recent deceleration, monetary conditions do not appear to be particularly austere on this basis, when compared with those in the early 1990s. However, the real rate of growth of broad money plus bank bills is not yet approaching the heights of 1985 or 1988. Over the 1986-88 period broader monetary growth was particularly rapid as commercial banks discovered that they could bypass the Statutory Reserve Deposit (SRD) requirements imposed on their deposit liabilities by issuing bank bills. However, after September 1988 SRD requirements were gradually dismantled and replaced by a more encompassing Prime Assets ratio for all banks.

AUSTRALIA: CHART 1
 BROAD MONEY PLUS BANK BILLS, INFLATION AND REAL GDP



AUSTRALIA: CHART 2
 GROWTH OF BUSINESS, HOUSING AND PERSONAL CREDIT



Credit Growth and Expenditures

Turning to the composition of credit, it is clear that the interest rate hikes in 1994 contributed to a slowdown in housing lending as illustrated in Chart 2 (around 40% of the total). However, the other significant components, namely credit extended to industry (which accounts for 50% of the total) and consumer credit continue to accelerate. Despite these mixed trends, total credit granted by all financial intermediaries to the private sector has maintained its long and uninterrupted acceleration -- in line with that in broad money -- and currently grows at 9% yoy (Chart 2).

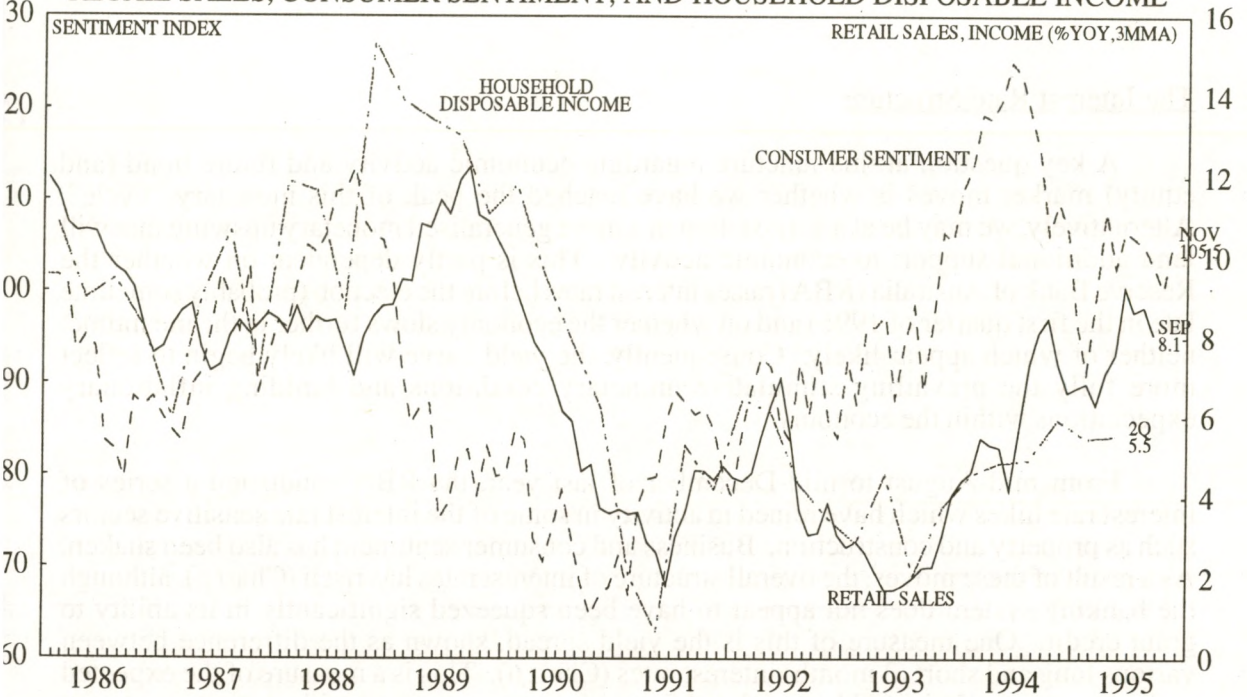
The higher interest rates implemented in 1994 resulted in mortgage rates being raised by around 3.5% in less than 6 months. As well as adversely affecting residential lending, dwelling approvals have continued to decline. Activity in the office property sector does not appear to have been as heavily affected although activity is more subdued in this economic cycle. Prime values for modern buildings in central Sydney have been rising since the 1993 trough (and stand at around A\$5000 per m²) but are nowhere near the levels reached in the late 1980s. Vacancy rates have been dropping to 15% although rents have hardly risen, at around A\$500 per m² p.a., again a long way from the peak of A\$700 per m² p.a. in 1990. Trends in Melbourne are similar, if more subdued.

Somewhat surprisingly, given the weakening in the residential housing market, consumption remains remarkably strong. Although consumer sentiment took a knock in 1994 other indicators look healthy. The current trend in disposable income and the upswing in total personal borrowing (Charts 2 and 3) suggest that the ingredients for continued expansion in consumption remain in place. Further interest rate hikes appear to be necessary to cool the pace of consumption, although the increased interest sensitivity of personal sector gearing implies that interest rates need not be raised as aggressively as in 1987-88 to achieve the same degree of restraint.

A year and a half ago, fixed capital expenditure was the weakest area of the economy in the current recovery. Since then capital expenditure has expanded and could be in the initial stages of cooling down (as shown in real terms in Chart 4). Capital spending booms have typically been around two years in length and unlike previous upswings this one got off to a slow start after the grinding corporate balance sheet restructuring of the early 1990s. Industrial production has also slowed in 1995 from the peak in 1994, while the accumulation of (non-commodity) inventories continues. Economic activity in the industrial areas of the economy appears to be experiencing a correction from the rapid expansion of 1994. However, given that business lending continues to accelerate it may be too early to judge the full effect of the earlier interest rate hikes on the availability of working capital and on capital spending itself.

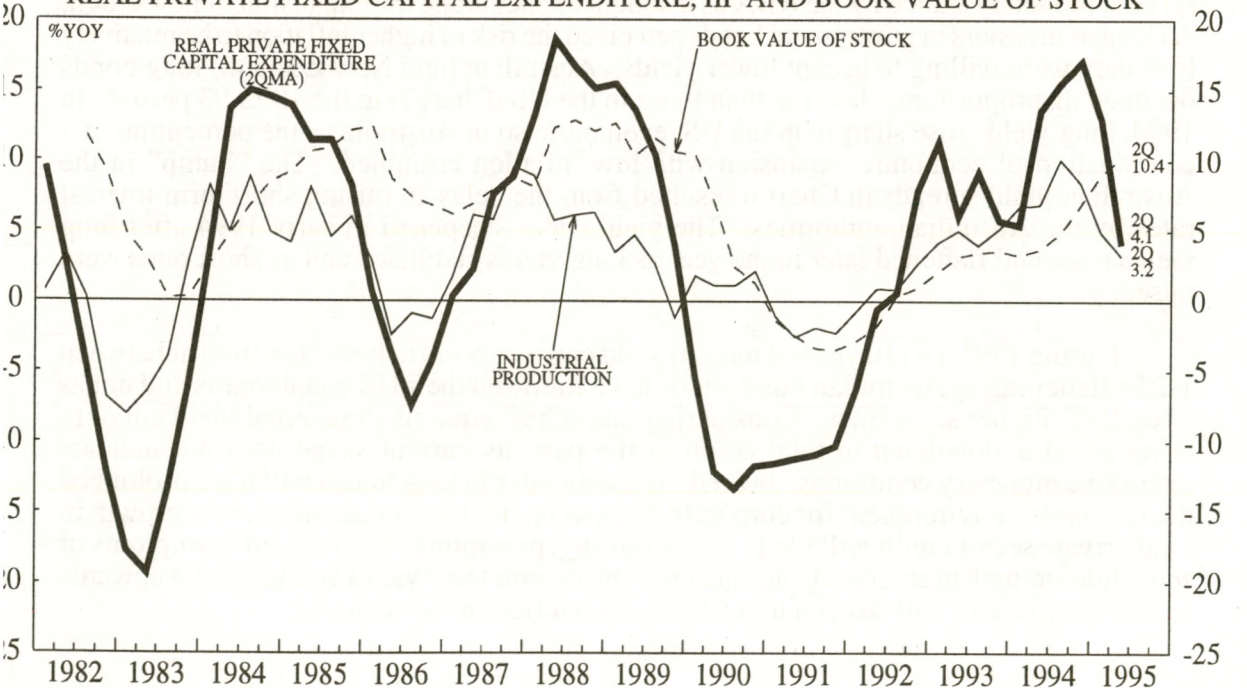
AUSTRALIA: CHART 3

RETAIL SALES, CONSUMER SENTIMENT, AND HOUSEHOLD DISPOSABLE INCOME



AUSTRALIA: CHART 4

REAL PRIVATE FIXED CAPITAL EXPENDITURE, IIP AND BOOK VALUE OF STOCK



The Interest Rate Structure

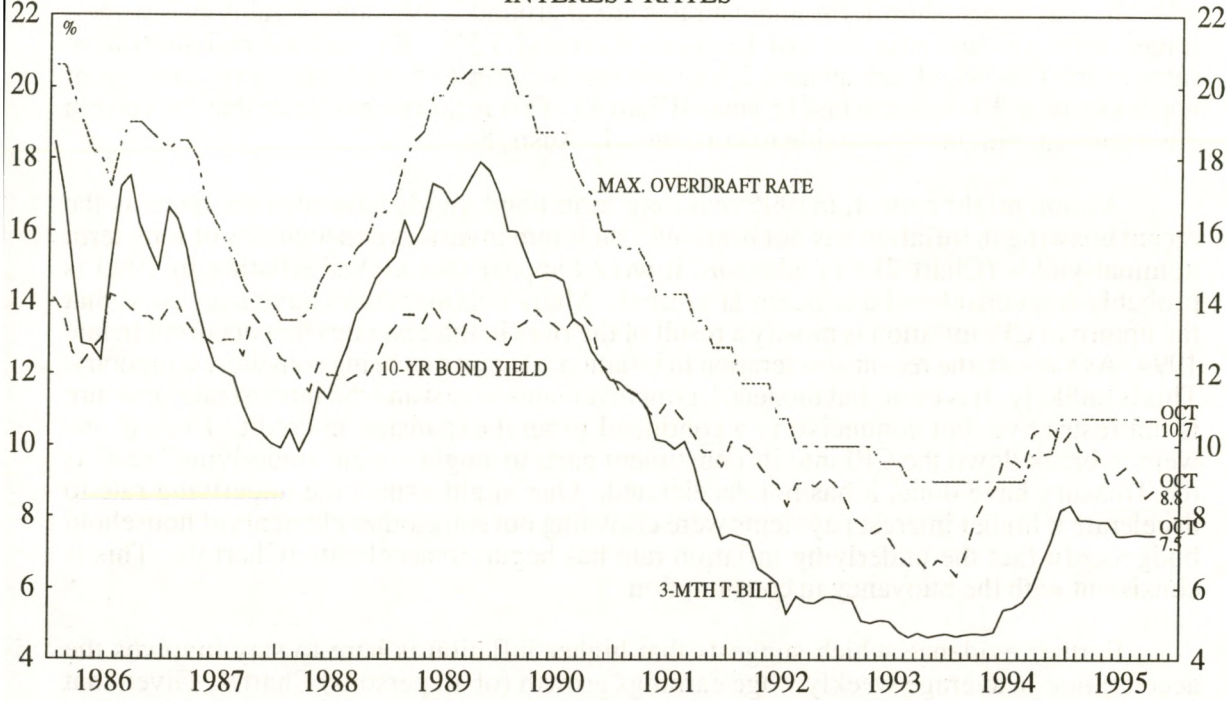
A key question at this juncture regarding economic activity and future bond (and equity) market moves is whether we have reached the peak of this monetary "cycle". Alternatively, we may be at a way-station in a more generalised monetary upswing that will lend additional support to economic activity. This is partly dependent on whether the Reserve Bank of Australia (RBA) raises interest rates before the election (probably sometime late in the first quarter of 1996) and on whether the economy slows further in the meantime, neither of which appear likely. Consequently, the yield curve will likely begin to reflect more fully the prevailing stimulative monetary conditions and building inflationary expectations within the economy.

From mid-August to mid-December of last year, the RBA conducted a series of interest rate hikes which have reined in activity in some of the interest rate sensitive sectors such as property and construction. Business and consumer sentiment has also been shaken. As a result of these moves, the overall structure of interest rates has risen (Chart 5), although the banking system does not appear to have been squeezed significantly in its ability to grant credit. One measure of this is the yield spread, shown as the difference between various long and short (3 month) interest rates (Chart 6). This is a measure of the expected real return on newly issued longer dated fixed income instruments with respect to the cost of short term credit.

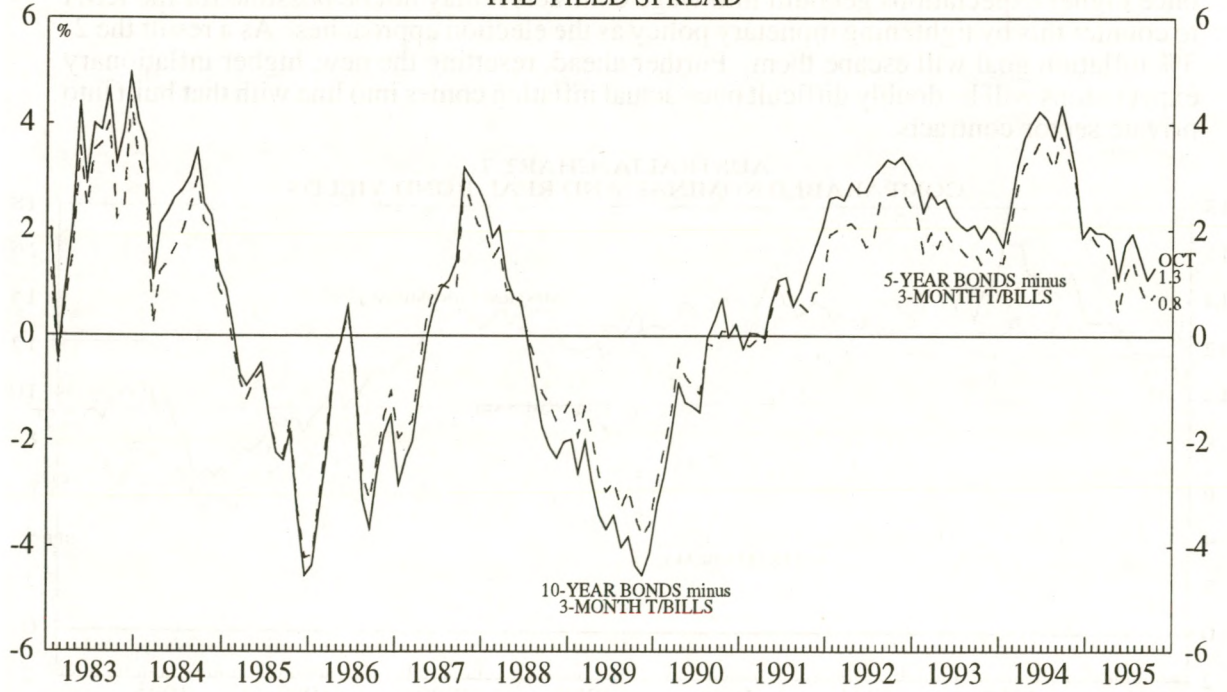
The large spread in 1992 (i.e. the steepness of the yield curve) reflected the deliberate relaxed monetary stance by the RBA as it sought to encourage the expansion of new credit. As long as investors in government bonds perceived the risk of higher inflation to be relatively low, they were willing to accept lower yields. Australian (and New Zealand) long bonds declined disproportionately more than those in the US (Chart 7) in the 1992-93 period. In 1994, long yields rose sharply in the US, even more so in Australia as the perception of a continuation of economic expansion with low inflation crumbled. The "hump" in the Australian yield spreads in Chart 6 resulted from the delay in raising short term interest rates by the Australian authorities. The yield curve steepened in early 1994 after long yields rose, and flattened later in the year as long yields stabilised and as short rates were raised.

During 1995 the (10 year - 3 month) yield curve appears to have stabilised at between 1-2%: flattening as Australian bond yields have followed their US counterparts and not as a result of higher short rates. Considering that it has required an inverted yield curve to bring about a slowdown in total credit in the past, its current shape does not indicate restrictive monetary conditions. Indeed the recent rally in long bonds will have prolonged the favourable environment for corporate borrowers. In the coming months the growth in total private sector credit will likely remain strong, prompting "unexpected" symptoms of economic strength to emerge. Consequently, longer term bond yields will be driven upwards and the yield curve will steepen to reflect revised inflation expectations.

AUSTRALIA: CHART 5
 INTEREST RATES



AUSTRALIA: CHART 6
 THE YIELD SPREAD



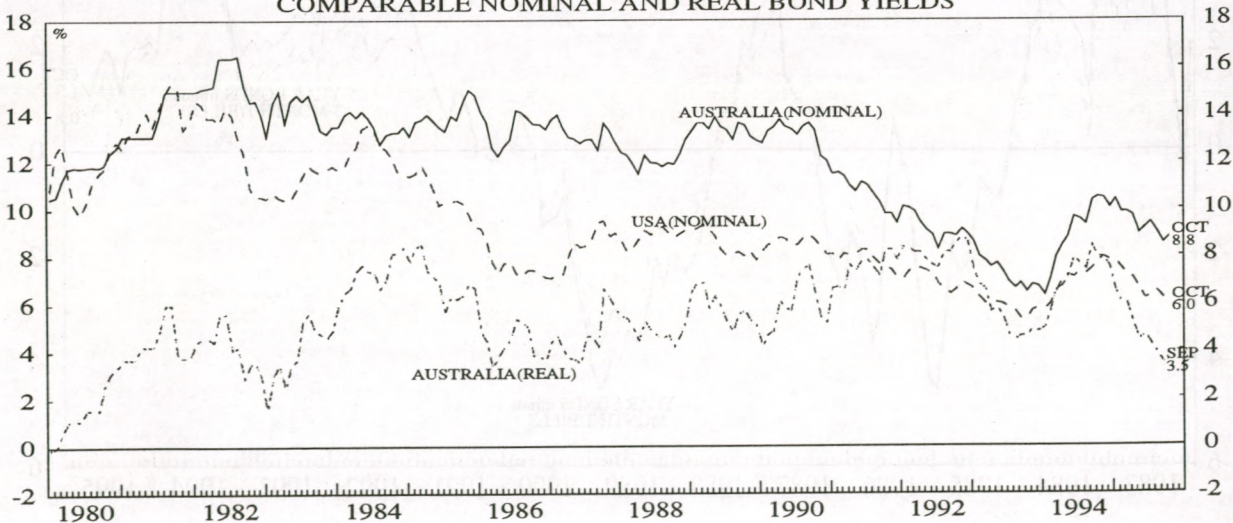
Real Interest Rates and Inflation

In real terms, short term interest rates are at around 2.3%, considerably below their longer term average over the last 15 years of around 5.3%. By contrast real short term rates in the US (which are around 2.6%) are much closer to their longer term average of approximately 3% over the last 15 years (Chart 8). This is further evidence that the current environment remains favourable to borrowers in Australia.

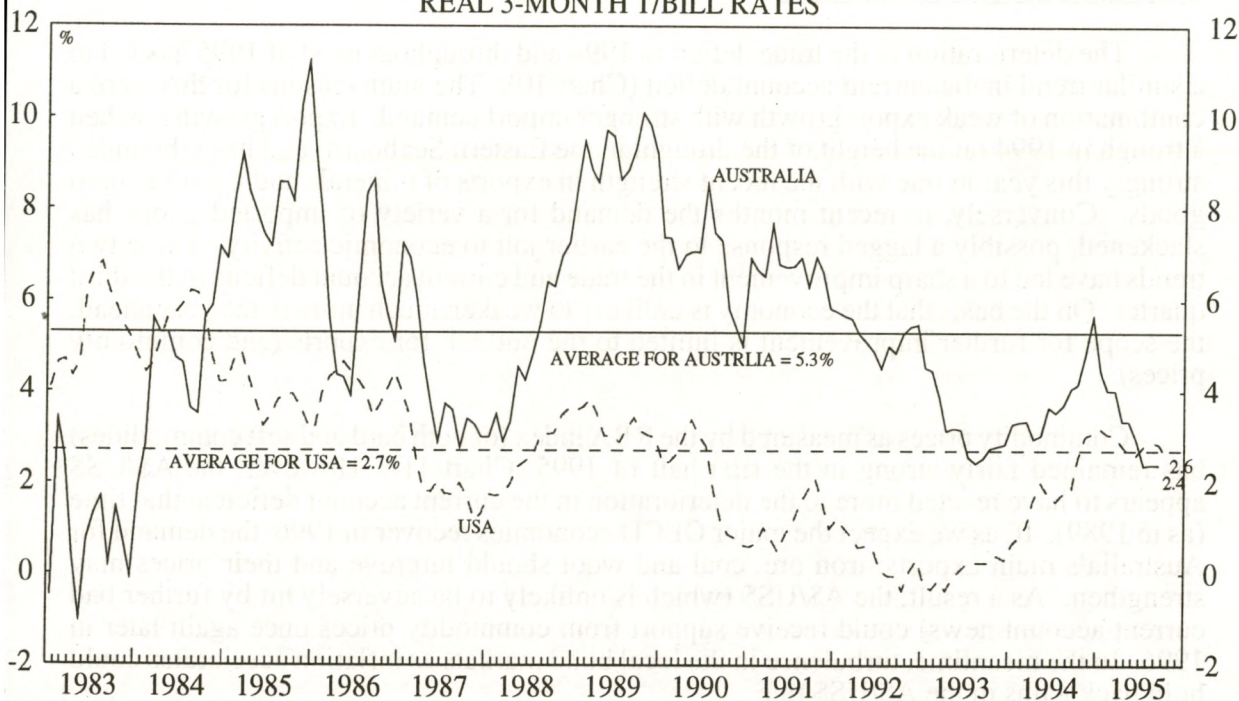
As one might expect, in 1995 real long term bond yields have also declined as the recent upswing in inflation has not been fully built into investors expectations of long term nominal yields (Chart 7). In addition, it would appear that higher inflation in 1996 is probably not considered a concern at present. Many commentators have suggested that the upturn in CPI inflation is mostly a result of the rises in interest rates that occurred in late 1994. As a result, the recent acceleration in inflation is viewed as being somehow temporary. This is unlikely. It is clear that monetary growth remains robust and the interest rate structure is not restrictive, but conducive to a continued general expansion in credit. Even if one were to break down the CPI into its constituent parts to single out an "underlying" rate, as the Treasury have done, it has not decelerated. One might expect the underlying rate to decelerate if higher interest payments were crowding out some other elements of household budgets. In fact the underlying inflation rate has begun to accelerate (Chart 9). This is consistent with the buoyancy in consumption.

Further evidence which suggests that higher inflation is here to stay involves the acceleration in average weekly wage earnings growth (of all persons) Chart 9. Given that Australia has retained a relatively high (though gradually diminishing) degree of unionisation and that the overall unemployment rate has now fallen to around 8.5% in line with the revival in the economy, unions are able to exercise greater bargaining power. These rigidities make the task of bringing down a higher rate of inflation more difficult for the RBA. Indeed once higher expectations get built into wage contracts it may not be possible for the RBA to counter this by tightening monetary policy as the election approaches. As a result the 2-3% inflation goal will escape them. Further ahead, resetting the new, higher inflationary expectations will be doubly difficult once actual inflation comes into line with that built into private sector contracts.

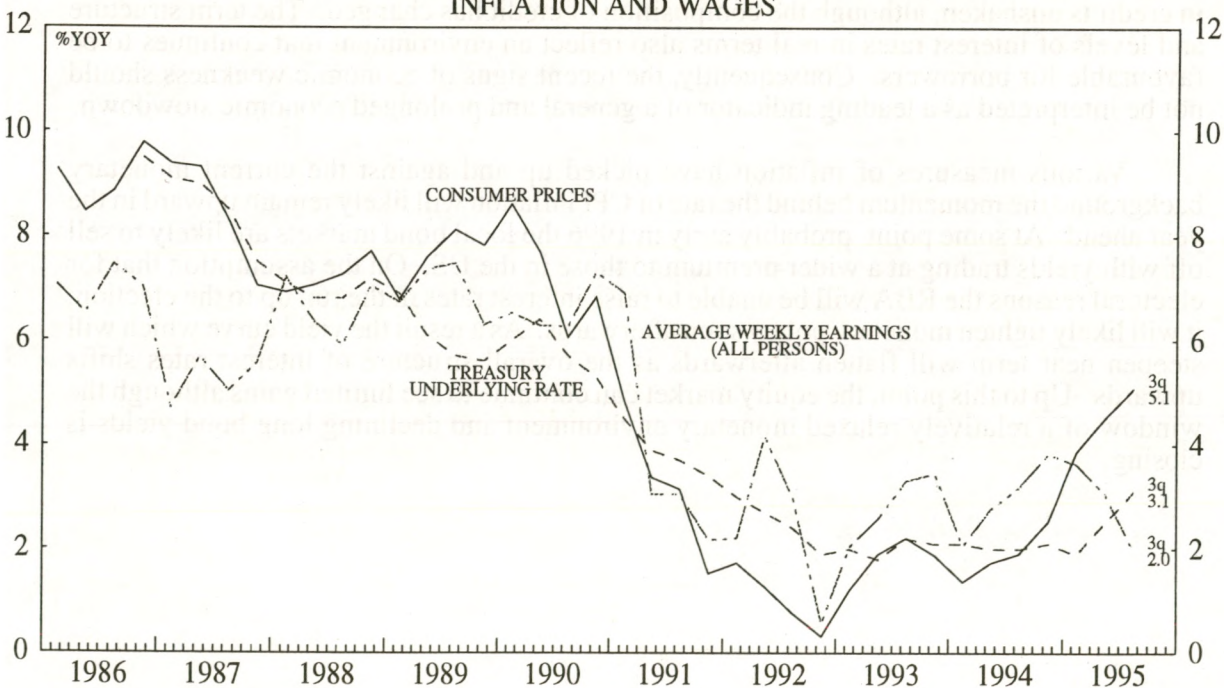
AUSTRALIA: CHART 7
COMPARABLE NOMINAL AND REAL BOND YIELDS



AUSTRALIA: CHART 8
REAL 3-MONTH T/BILL RATES



AUSTRALIA: CHART 9
INFLATION AND WAGES



Outlook for the Current Account

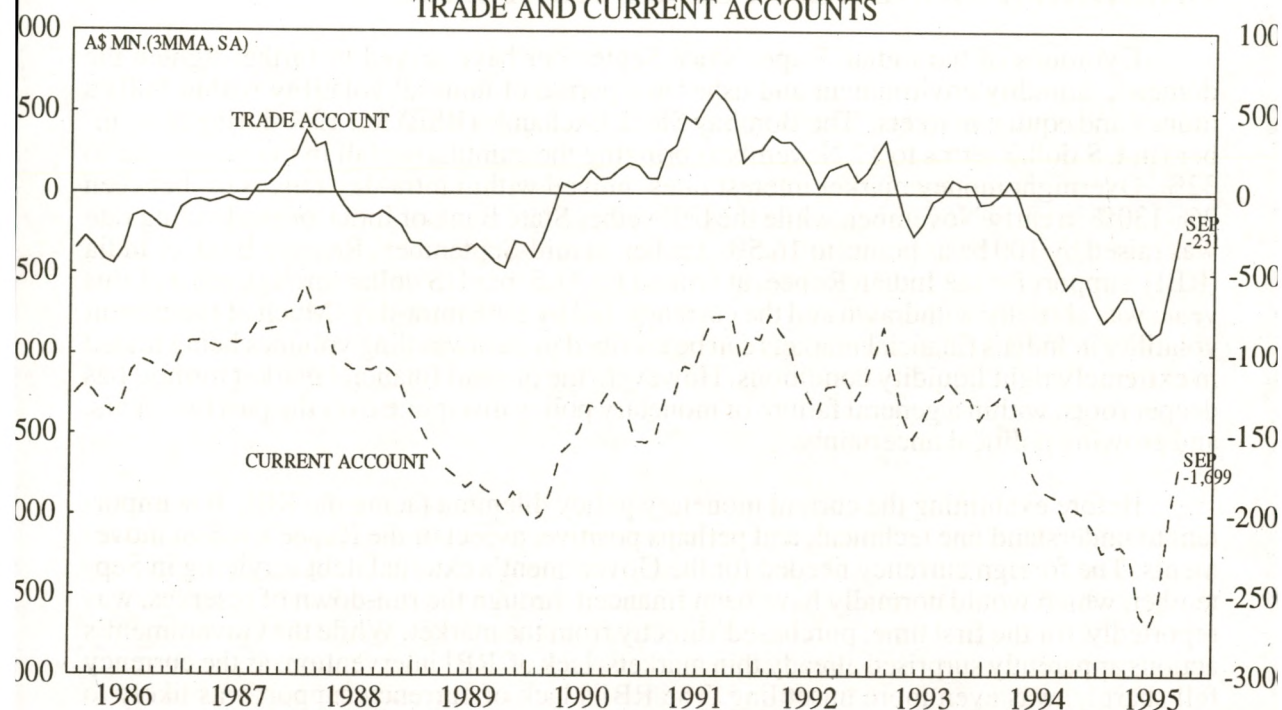
The deterioration in the trade deficit in 1994 and throughout most of 1995 has led to a similar trend in the current account deficit (Chart 10). The main reasons for this were a combination of weak export growth with stronger import demand. Export growth reached a trough in 1994 (at the height of the drought in the Eastern Seaboard) and has rebounded strongly this year in line with the recent strength in exports of minerals and manufactured goods. Conversely, in recent months the demand for a variety of imported goods has slackened, possibly a lagged response to the earlier jolt to economic activity. These two trends have led to a sharp improvement in the trade and current account deficits in the third quarter. On the basis that the economy is unlikely to weaken much more in the year ahead, the scope for further improvement is limited to the outlook for exports (and commodity prices).

Commodity prices as measured by the RBA index (of both hard and soft commodities) has remained fairly strong in the first half of 1995 (Chart 11). However, the A\$/US\$ appears to have reacted more to the deterioration in the current account deficit at that time (as in 1989). If, as we expect the major OECD economies recover in 1996, the demand for Australia's main exports: iron ore, coal and wool should improve and their prices may strengthen. As a result, the A\$/US\$ (which is unlikely to be adversely hit by further bad current account news) could receive support from commodity prices once again later in 1996. In the meantime, turbulence in the local bond markets as inflation accelerates could hold back gains in the A\$/US\$ rate.

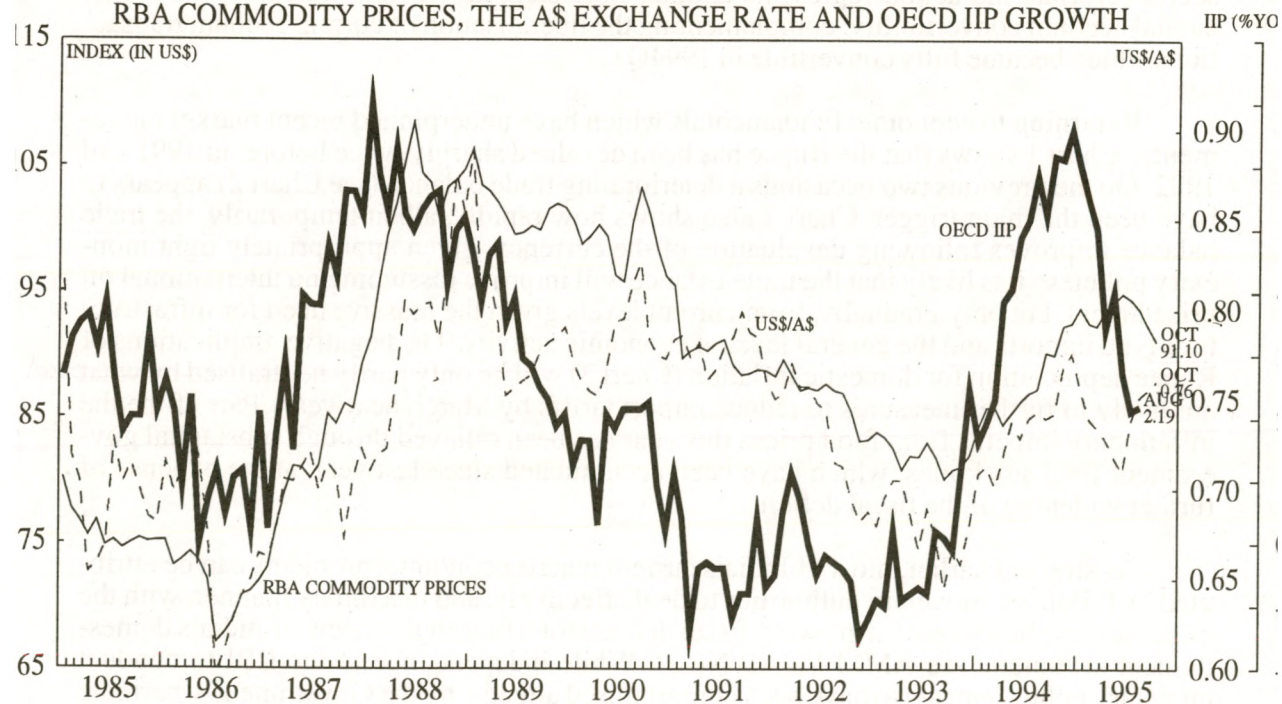
SUMMARY AND CONCLUSIONS: There continues to be a great deal of focus on the (mixed) state of domestic economic activity, in the aftermath of the rises in interest rates last year. However, recent monetary trends remain buoyant and the general upward trend in credit is unshaken, although the composition of credit has changed. The term structure and levels of interest rates in real terms also reflect an environment that continues to be favourable for borrowers. Consequently, the recent signs of economic weakness should not be interpreted as a leading indicator of a general and prolonged economic slowdown.

Various measures of inflation have picked up and against the current monetary background the momentum behind the rate of CPI inflation will likely remain upward in the year ahead. At some point, probably early in 1996 the local bond markets are likely to sell off with yields trading at a wider premium to those in the US. On the assumption that for electoral reasons the RBA will be unable to raise interest rates in the run up to the election, it will likely tighten monetary policy soon afterwards. As a result the yield curve which will steepen near term will flatten afterwards as the overall structure of interest rates shifts upwards. Up to this point, the equity market can continue to see limited gains although the window of a relatively relaxed monetary environment and declining long bond yields is closing.

AUSTRALIA: CHART 10
TRADE AND CURRENT ACCOUNTS



AUSTRALIA: CHART 11
RBA COMMODITY PRICES, THE A\$ EXCHANGE RATE AND OECD IIP GROWTH



INDIA WALKING A MONETARY POLICY HIGH WIRE

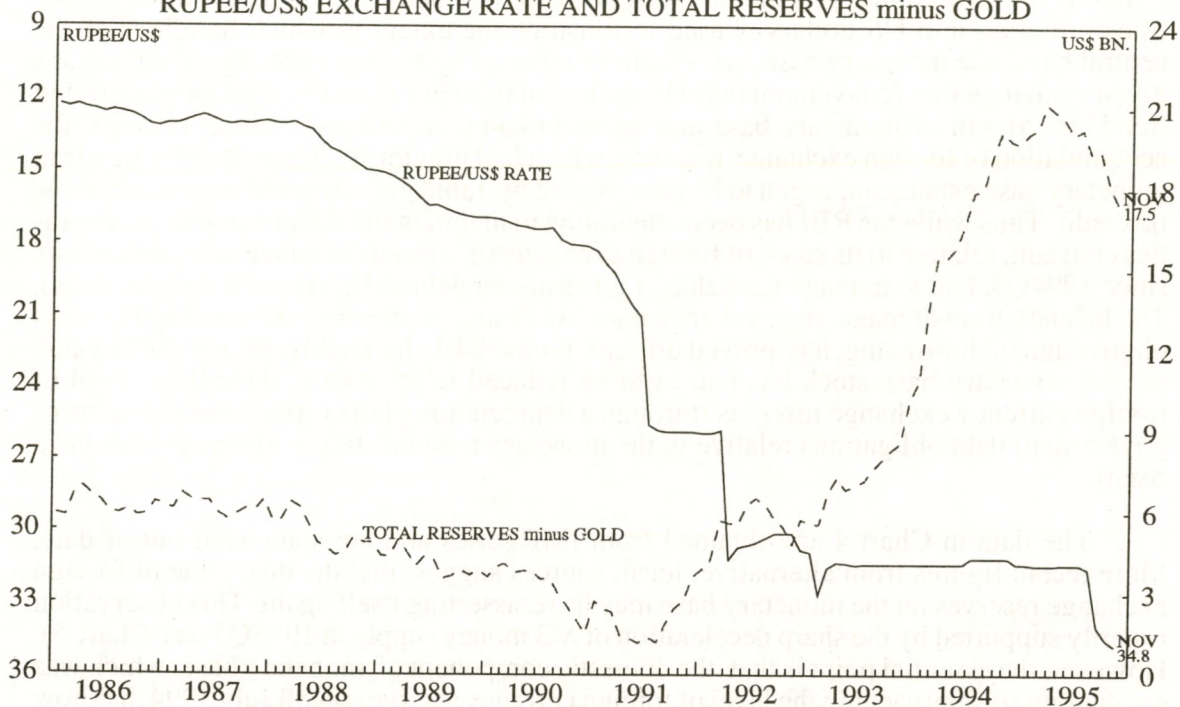
Gyrations of the Indian Rupee since September have served to further tighten the domestic liquidity environment and usher in a period of unusual volatility within India's money and equity markets. The Bombay Stock Exchange (BSE) fell 12% during November (in US dollar terms to 17 November) bringing the cumulative fall in the year so far to 32%. Overnight money market interest rates moved within intra-day ranges of between 2%-130% in early November, while the bellwether State Bank of India prime lending rate was raised by 100 basis points to 16.5%. Earlier, in mid-September, Reserve Bank of India (RBI) support for the Indian Rupee, at around Rs 31.5 per US dollar through most of this year, was abruptly withdrawn and the currency fell by 10% intra-day. Much of the current volatility in India's financial markets can be ascribed to the dwindling volumes being traded in extremely tight liquidity conditions. However, the present financial market turmoil has deeper roots, within a general failure of monetary policy discipline over the past two years, and growing political uncertainty.

Before examining the current monetary policy dilemma facing the RBI, it is important to understand one technical, and perhaps positive, aspect of the Rupee's recent movements. The foreign currency needed for the Government's external debt servicing in September, which would normally have been financed through the run-down of reserves, was reportedly, for the first time, purchased directly from the market. While the Government's actions apparently surprised already thin markets, lack of RBI intervention, as the currency fell sharply, was even more unsettling. The RBI's lack of currency support was likely to have been motivated by three factors: a steady deterioration of the trade balance through 1995; a need to absorb growing inflation differentials between India and its trading partners; and a strengthening of the US dollar. However, in the broader context of financial sector reforms, the action represents another bold step, albeit mis-timed, towards full capital account convertibility; complementing the liberalisation of current account transactions which became fully convertible in 1994Q1.

Returning to economic fundamentals which have underpinned recent market movements, Chart 1 shows that the Rupee has been devalued sharply twice before, in 1991 and 1992. On the previous two occasions a deteriorating trade balance (see Chart 2) appears to have been the main trigger. Chart 2 also shows how rapidly, albeit temporarily, the trade balance improves following devaluation of the currency, given appropriately tight monetary policies. It is likely that the trade balance will improve (assuming no international oil price hikes), but only gradually, from current levels given the massive need for infrastructure-type imports and the general level of economic activity. The negative implications of Rupee depreciation for domestic inflation (Chart 3) will be only partly neutralised by what are likely to be further measures to reduce import tariffs by March next year. Part of the inflationary impetus from food prices this year has been relieved through substantial government food stockpiles, which have been accumulated since last year, at the expense of further widening of the fiscal deficit.

As stressed earlier, most of India's current macro-economic problems can be attributed to failure of monetary authorities to deal effectively, and in a timely manner, with the monetary implications of a growing fiscal deficit (for a thorough review of India's domestic debt arithmetic see AMM Vol 19 No 3). While independence of the RBI to conduct monetary policy appears to have been compromised already, by the Government's periodic straying from its debt monetisation ceilings, the issue for the moment is wresting control of the monetary base.

INDIA: CHART 1
RUPEE/US\$ EXCHANGE RATE AND TOTAL RESERVES minus GOLD



INDIA: CHART 2
TRADE PERFORMANCE

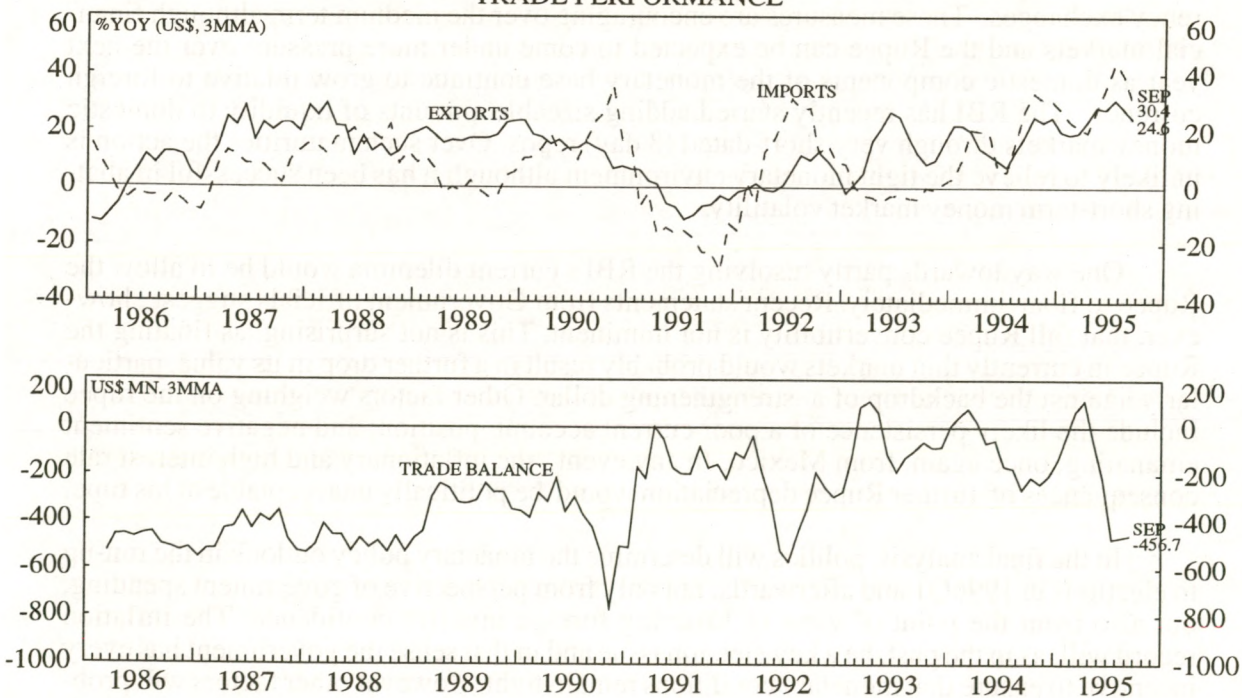


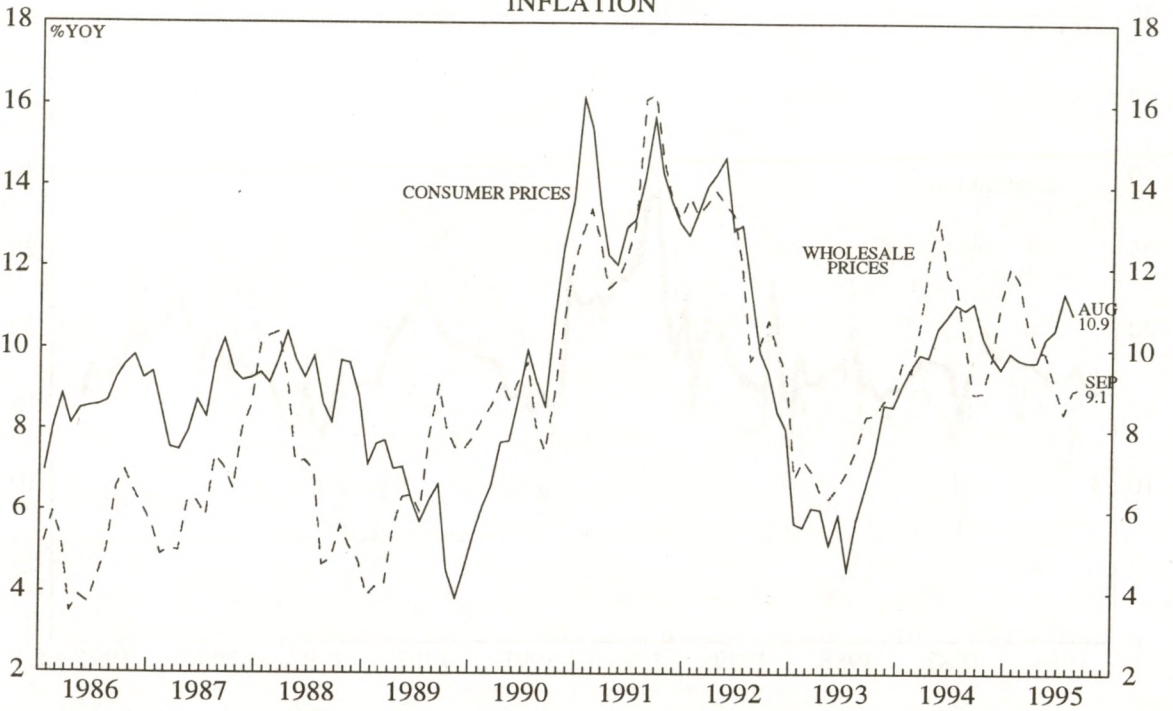
Chart 4 expresses the monetary base and its two main components in US dollar terms. It is conventional practice to express Chart 4 in domestic currency, however the transformation into US dollars is used to illustrate the extent to which liabilities of the central bank, the monetary base, are able to be covered by foreign exchange reserves, at a given exchange rate (conversion into US dollars in this case does not alter the underlying trends in growth of monetary base and its two main components). Since 1994Q3, the accumulation of foreign exchange reserves, which had previously dominated the trends in monetary base expansion, began to be undermined by rapid growth in central bank domestic credit. Thus while the RBI has been attempting to maintain the dollar value of its liabilities constant, relative to its stock of foreign exchange (ie a fixed exchange rate), it has also, since 1994Q3, had to manage the value of government debt obligations (ie interest rates). The balancing act of managing exchange rates, while at the same time minimising the costs of government borrowing, has proved difficult for the RBI. Inevitably, the US dollar value of the monetary base stock has had to be reduced relative to a dwindling pool of foreign currency exchange reserves (through a depreciation of the rupee); and the value of government debt obligations relative to the monetary base has fallen (interest rates have risen).

The data in Chart 4 are obtained from IMF series and are somewhat out of date. More recent figures from alternative, local, sources suggest that the discipline of foreign exchange reserves on the monetary base may be re-asserting itself again. This observation is partly supported by the sharp deceleration of M3 money supply in 1995Q3 (see Chart 5). However, the essential point is that the domestic component of monetary base, which was encouragingly approaching the level of foreign currency reserves up till July 1994, has now grown to worryingly high levels (as in 1991). September's "busy season" Credit Policy, and subsequent announcements, have included various measures designed to lure back foreign investors and foreign currency generally. Limits on banks' foreign exchange trading activity have also been further liberalised, deepening the liquidity of Rupee trading on the currency exchanges. These measures are encouraging over the medium term although financial markets and the Rupee can be expected to come under more pressure over the next year as domestic components of the monetary base continue to grow relative to foreign currency. The RBI has recently started adding sizeable amounts of liquidity to domestic money markets through very short-dated (3 day) repos. Over such maturities the action is unlikely to relieve the tight monetary environment although it has been successful in abating short-term money market volatility.

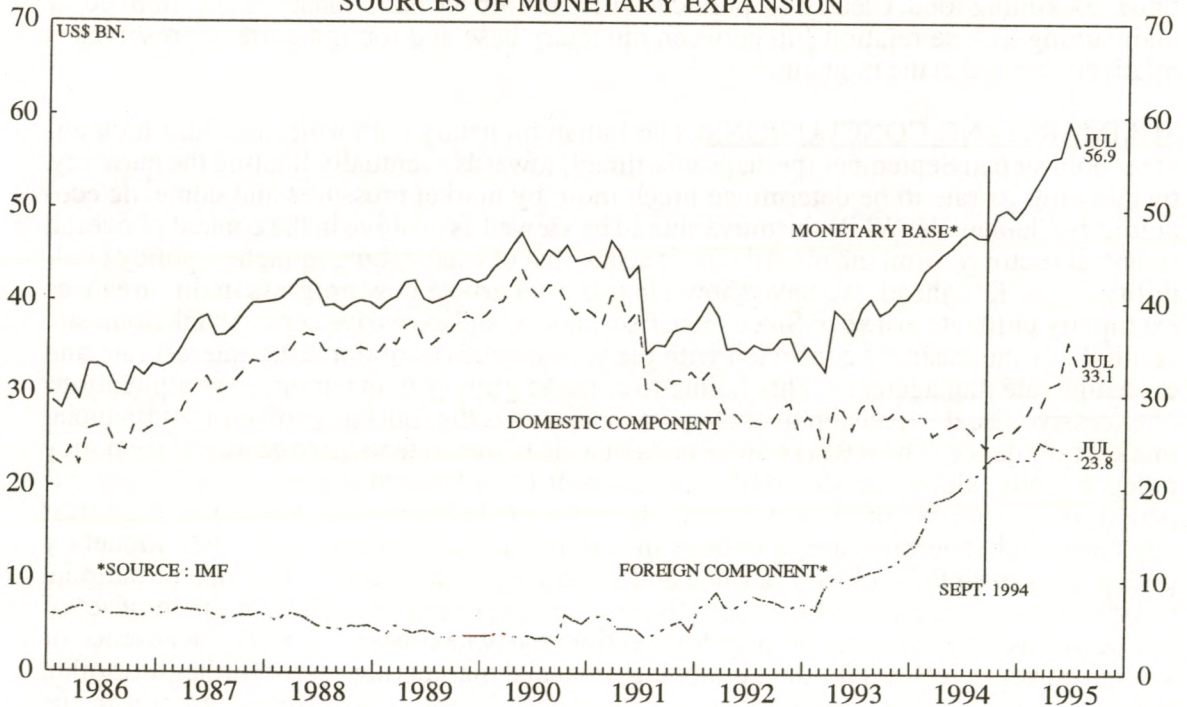
One way towards partly resolving the RBI's current dilemma would be to allow the Rupee to float immediately. Recent statements from Government officials suggest, however, that full Rupee convertibility is not imminent. This is not surprising, as floating the Rupee in currently thin markets would probably result in a further drop in its value, particularly against the backdrop of a strengthening dollar. Other factors weighing on the rupee include the likely persistence of a poor current account position; and negative sentiment emanating, once again, from Mexico. In any event, the inflationary and high interest rate consequences of further Rupee depreciation would be politically unacceptable at his time.

In the final analysis, politics will determine the monetary policy outlook in the run-up to elections in 1996Q1 and afterwards; not only from perspective of government spending, but also from the point of view of fostering foreign investor confidence. The inflation record will, as in the past, be a key election issue and in that sense the government has every incentive to ensure that monetary conditions remain tight. However other factors will probably ensure a further widening of the fiscal deficit up to the elections, and a consequent

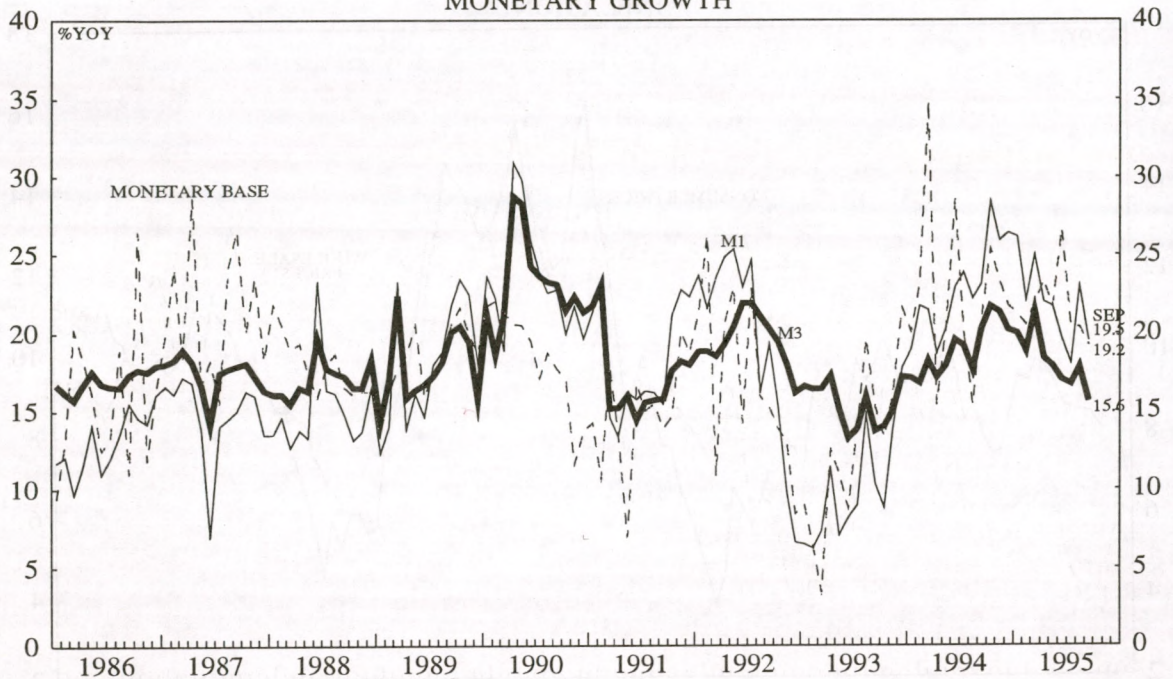
INDIA: CHART 3
INFLATION



INDIA: CHART 4
SOURCES OF MONETARY EXPANSION



INDIA: CHART 5
MONETARY GROWTH



expansion of the domestic monetary base component. These factors include the usual pre-election sweeteners, a poor response to Government privatisation issues, the need to tread carefully with restructuring programs (such as the "EXIT" policy), and the need to continue stockpiling food. Clearly the political will to absorb the deflationary "pain" implied by maintaining a close relationship between monetary base and foreign currency reserves is relatively limited at the moment.

SUMMARY AND CONCLUSIONS: The Indian monetary authorities recently took another bold step in September (perhaps mis-timed) towards eventually floating the currency, by allowing its rate to be determined much more by market pressures and domestic economic fundamentals. While the move should be viewed as positive in the context of overall financial sector reform, the most difficult task - that of establishing monetary policy credibility - now lies ahead. We have shown in this brief article how progress in this area was exemplary until late last year. Since then, fiscal laxity, and excessive central bank domestic credit, have increasingly conflicted with the twin objectives of domestic interest rate and exchange rate management. This failure to come to grips with the monetary implications of excessive fiscal expansion over the past two years is the root cause of current financial market turbulence. The RBI is now in need of a clear mandate to manage monetary policy independently, alongside a credible commitment from Government to reduce fiscal expenditure and the extent of central bank domestic credit expansion. Moreover, if interest rates and exchange rates are to behave in a stable and predictable way, then monetary policy rules need to be clearly defined and steadfastly implemented. In terms of national priorities however, the need for such discipline is likely to feature low in the mindset of politicians as they currently prepare for elections early next year. Thus, in the absence of foreign currency inflows for the time-being, financial markets are set for further turmoil in the year ahead, with equity markets and the Rupee likely to lose further ground in the process.

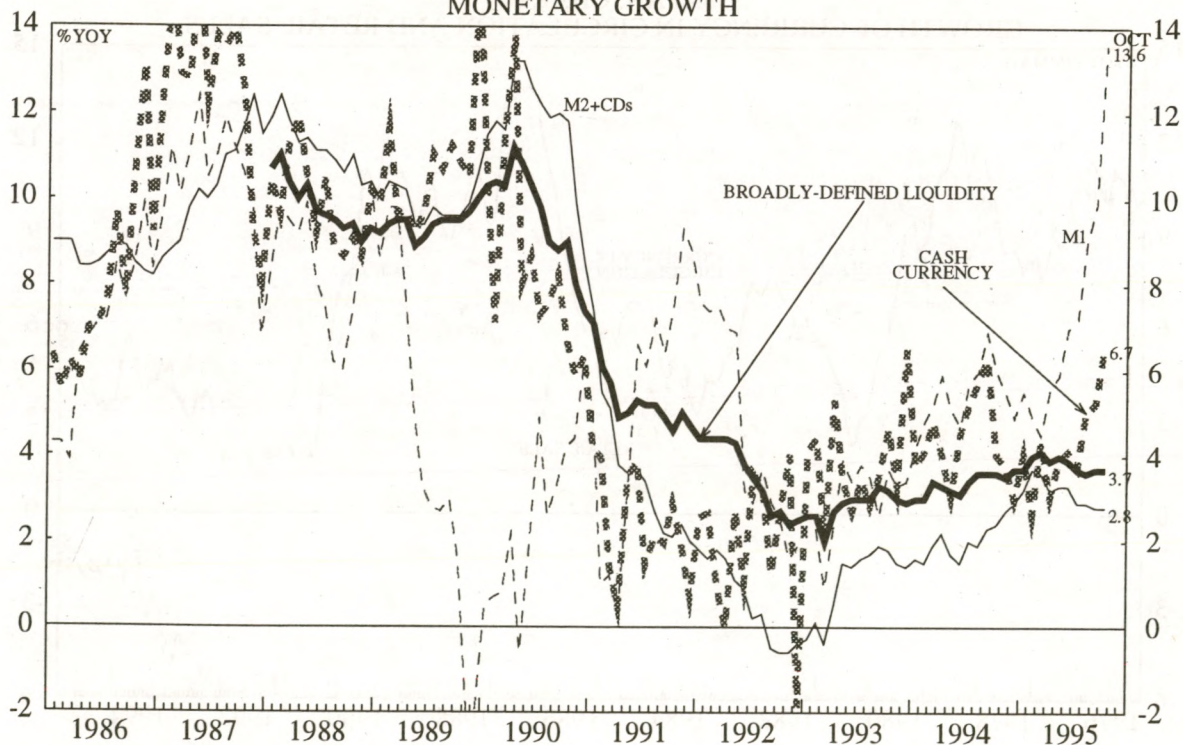
JAPAN RISING LIQUIDITY PREFERENCE OF MONEY DEMAND

Recent months have seen a marked divergence between various monetary indicators in Japan. On the one hand narrow definitions of the money supply have accelerated dramatically and bank lending (which had previously been falling) has started to grow modestly, while on the other hand broader monetary and liquidity aggregates remain very subdued (see chart 1). Other indicators are also mixed. The yen has weakened by over 25% from its peak, but is still stronger than most Purchasing Power Parity type valuations and only back to the level it was at in the middle of 1994. Short-term nominal interest rates have come down to historically low levels, while deflation and a steep yield curve means that real long-term rates are still high (see chart 2). Meanwhile rising concerns about Japan's banking system have prompted international markets to impose risk-premiums of varying degrees on Japanese banks, obscuring the useful information on monetary conditions contained in 'pure' interest rates with the addition of heightened borrower-specific risk-premia. This article attempts to reconcile these various conflicting signals about current monetary conditions in Japan.

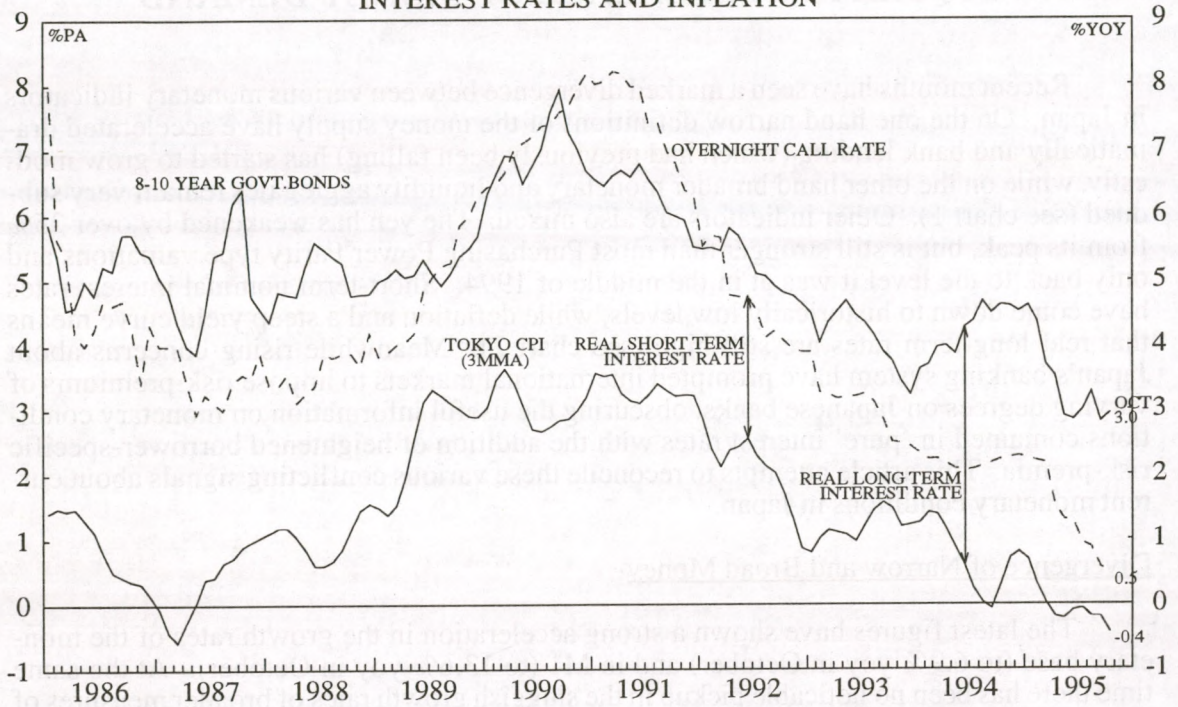
Divergence of Narrow and Broad Money

The latest figures have shown a strong acceleration in the growth rates of the monetary base (to 6.9% yoy in October) and in M1 (to 13.6% yoy in October). At the same time there has been no noticeable pickup in the sluggish growth rates of broader measures of money, such as M2+CDs (2.8% yoy in October) and broad liquidity (3.7% yoy in October).

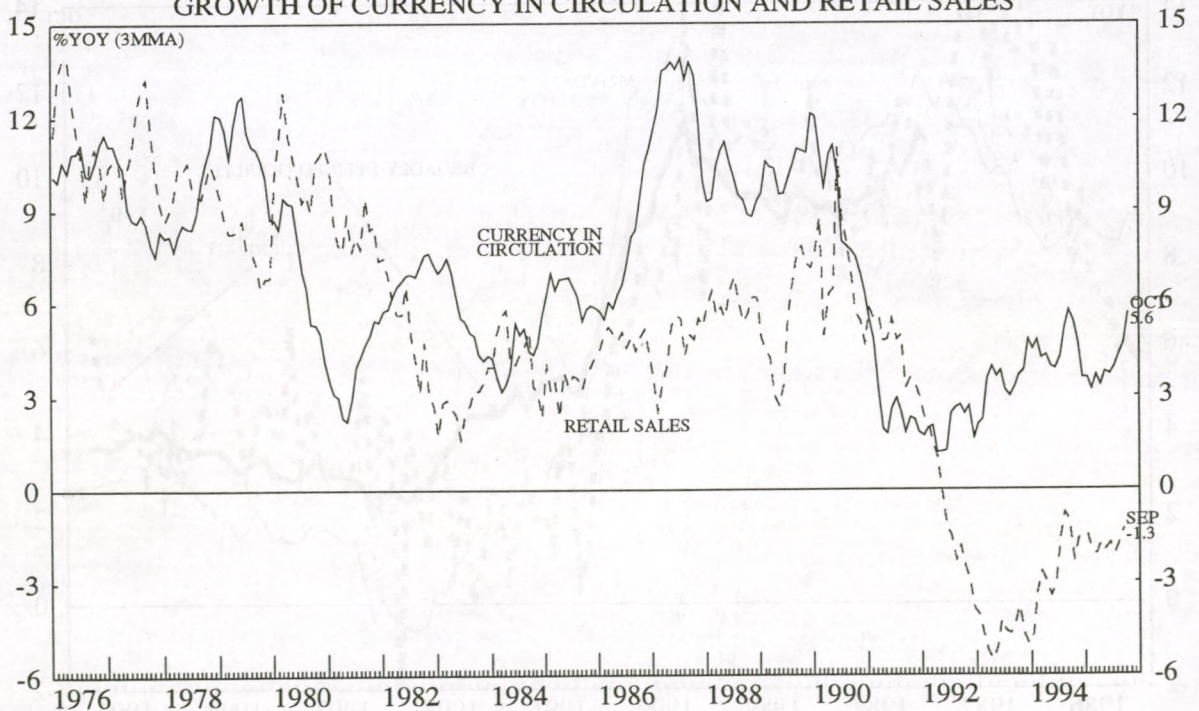
JAPAN: CHART 1
MONETARY GROWTH



JAPAN: CHART 2
INTEREST RATES AND INFLATION



JAPAN: CHART 3
GROWTH OF CURRENCY IN CIRCULATION AND RETAIL SALES



As narrow definitions of money are subsets of broader definitions of the money supply, the combination of stagnant broad money and accelerating narrow money is not wholly consistent with an acceleration in the total supply and demand for money. Rather, it would be symptomatic of a change in the relative demand for different types of money, in this case an increased liquidity preference. This is manifested by a so far modest rise in the cash/deposits ratio (over and above the seasonal fluctuation pattern) and a rise in liquid money balances ($M1 = \text{cash currency plus demand deposits}$) as a proportion of total broad money ($M2 + \text{CDs} = M1 + \text{time deposits} + \text{CDs}$).

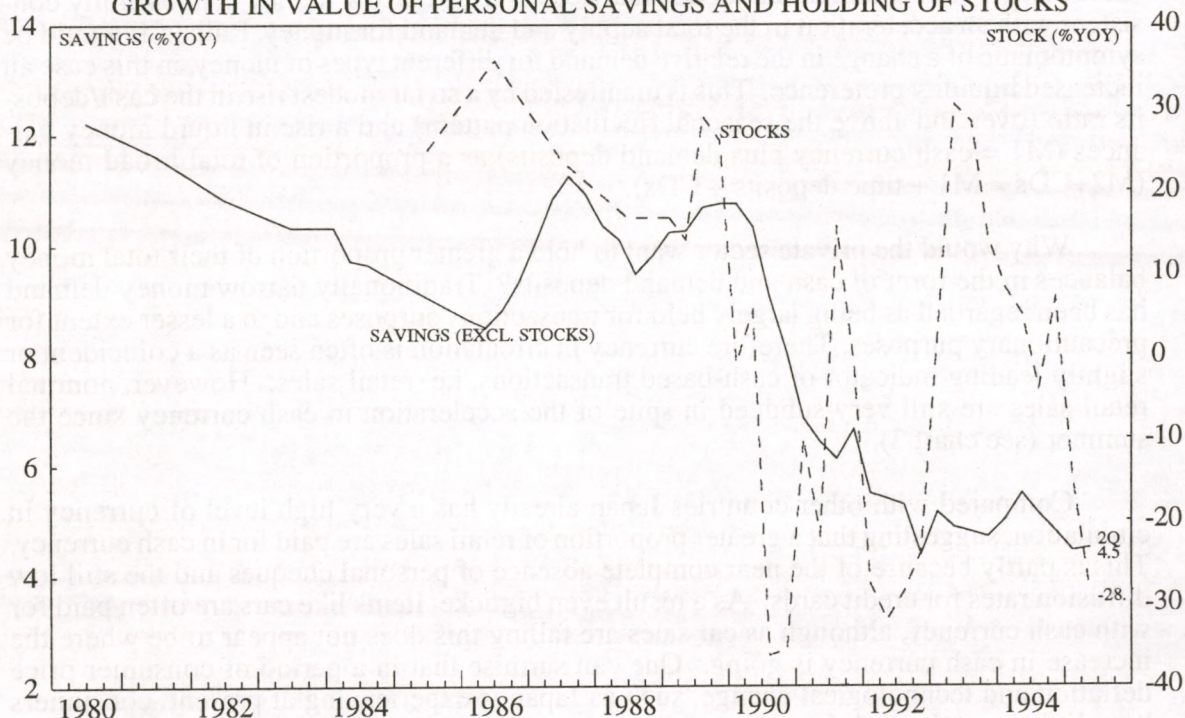
Why would the private sector want to hold a greater proportion of their total money balances in the form of cash and demand deposits? Traditionally narrow money demand has been regarded as being largely held for transactions purposes and to a lesser extent for precautionary purposes. Therefore currency in circulation is often seen as a coincident or slightly leading indicator of cash-based transactions, i.e. retail sales. However, nominal retail sales are still very subdued in spite of the acceleration in cash currency since the summer (see chart 3).

Compared with other countries Japan already has a very high level of currency in circulation, suggesting that a greater proportion of retail sales are paid for in cash currency. This is partly because of the near complete absence of personal cheques and the still low diffusion rates for credit cards. As a result even bigticket items like cars are often paid for with cash currency, although as car sales are falling this does not appear to be where the increase in cash currency is going. One can surmise that in a period of consumer price deflation and technological change, such as Japan is experiencing at present, consumers have little incentive to bring forward discretionary purchases of consumer durables which look set to be available more cheaply and/or in better quality in the future.

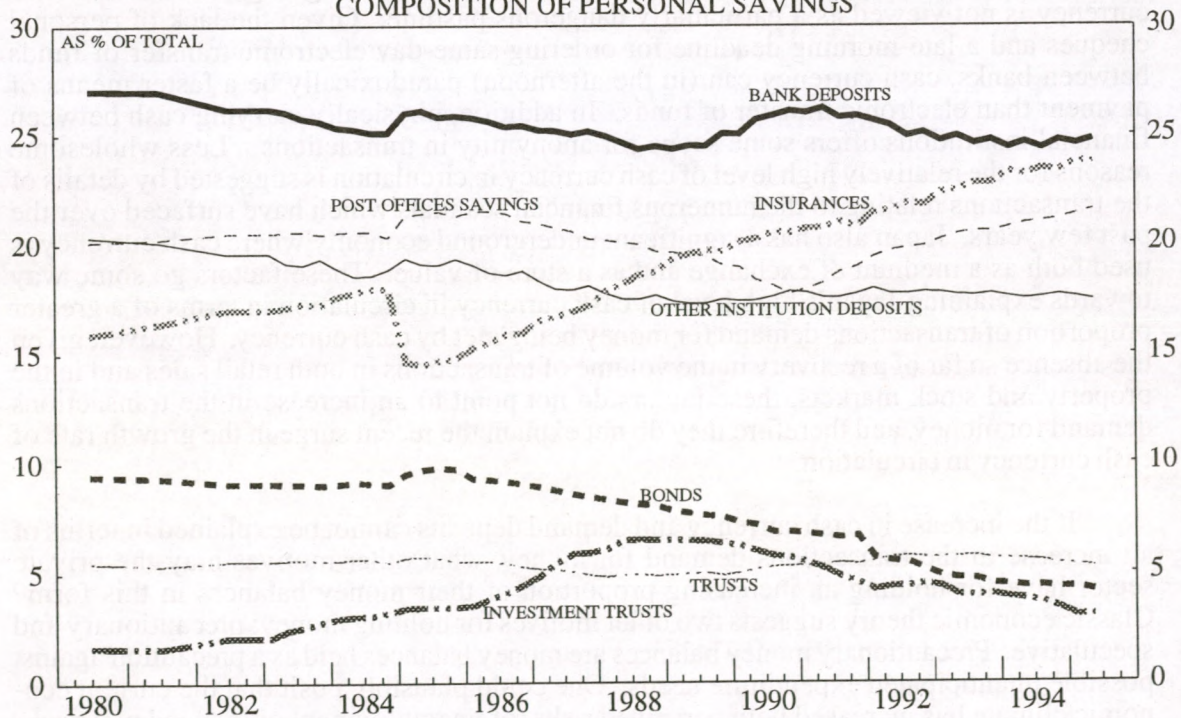
Given the low incidence of violent crime in Japan, carrying large amounts of cash currency is not viewed as a particularly dangerous pastime. Given the lack of personal cheques and a late-morning deadline for ordering same-day electronic transfer of funds between banks, cash currency can (in the afternoon) paradoxically be a faster means of payment than electronic transfer of funds. In addition, physically carrying cash between financial institutions offers some scope for anonymity in transactions. Less wholesome reasons for the relatively high level of cash currency in circulation is suggested by details of the transactions relating to the numerous financial scandals which have surfaced over the past few years. Japan also has a significant underground economy where cash currency is used both as a medium of exchange and as a store of value. These factors go some way towards explaining Japan's high level of cash currency in circulation in terms of a greater proportion of transactions demand for money being met by cash currency. However, given the absence so far of a recovery in the volume of transactions in both retail sales and in the property and stock markets, these factors do not point to an increase in the transactions demand for money, and therefore they do not explain the recent surge in the growth rate of cash currency in circulation.

If the increase in cash currency and demand deposits cannot be explained in terms of an increase in the transactions demand for money, what other motives may the private sector have for holding an increasing proportion of their money balances in this form? Classic economic theory suggests two other motives for holding money: precautionary and speculative. Precautionary money balances are money balances held as a precaution against possible unanticipated expenditure needs. One could plausibly posit that the current economic climate has increased both perceived risks (of unemployment or reduced pay packets) and perceived opportunities (for future 'cheap' bargains in retail sales and, less plausi-

JAPAN: CHART 4
GROWTH IN VALUE OF PERSONAL SAVINGS AND HOLDING OF STOCKS



JAPAN: CHART 5
COMPOSITION OF PERSONAL SAVINGS



bly at this stage, in asset markets), which could have gradually increased the demand for cash and demand deposits for precautionary motives. However, these developments have been gradual rather than sudden and therefore do not explain the recent abrupt surge in cash currency and in demand deposits.

As the recent rapid increase in cash currency and demand deposits cannot be satisfactorily explained in terms of increased money demand for transactions purposes or precautionary purposes, the only remaining reason would be increased demand for narrow money for speculative purposes. The concept of holding cash currency or demand deposits, both assets with zero nominal yield and no scope for nominal capital gain, for speculative purposes may at first seem rather odd. However, seen within the context of the overall asset allocation decisions of Japanese savers, and considering what has happened to other asset classes in Japan, the concept of speculative demand for cash makes more sense.

Changing Personal Savings

The Personal Savings Table in the Bank of Japan's Economic Statistics Monthly provides some interesting insights into the behaviour of personal savings. However, it should be noted that although this table includes the main types of financial savings (including deposits with banks, post office savings, and other financial institutions, as well as trust deposits, investment trusts, domestic bonds and insurance policies), it only includes personal holdings of stocks as a memo item, and does not include the main item of personal sector wealth in Japan, namely property. Another item excluded from the table is personal sector holdings of cash currency. When cash is held solely for transactions purposes this omission is correct, but when cash is held for precautionary and even speculative purposes it makes less sense.

One of the trends discernible from the table is the halving of the growth rate of savings (excluding stocks) from over 10% annually in the late 1980s to around 5% in the early 1990s (see chart 4). Various explanations can be posited for this slowdown in the growth rate of savings, with possible factors including changing demographic conditions (i.e. more dissaving by old retired people), lower disposable incomes (limiting the scope for new savings) and lower nominal rates of return on various savings instruments.

There has also been a noticeable change in the 'market share' of various types of savings instruments (see chart 5). Portfolio theory suggests that investors will seek to maximise the risk-adjusted expected rate of return on their overall portfolio, with the risk adjustment being a function of historical volatility, perceived future risk and investors' appetite for risk (the slope of the investor's risk/reward indifference curve). In a perfect market, the ex-ante risk-adjusted rate of return on all asset classes should equalise. However, the market for Japanese savings is by no means a perfect market. The rates of return on savings instruments have long been over-regulated, and the risks that the liabilities of financial institutions (i.e. deposits, trusts, insurance policies, etc.) might not be fully matched by assets has been conveniently ignored and swept under the carpet by government re-assurances. Therefore, until recent credit union and bank failures, credit risk has not been a major consideration in portfolio decisions by Japanese savers. Except insofar as savers have ventured into the stock market, they have also to a large extent felt protected from market risks by most savings instruments (especially trust money and investment trusts) having 'pledged rates of return'. Therefore financial institutions have mainly competed for savings on the basis of their ability to offer high rates of return, as constrained by regulations, collusive practices and accounting conventions.

The value of personal sector holdings of stocks (equities) almost doubled from 52.6 trillion yen at the end of 1985 to 102.8 trillion yen at the end of 1988, and has since almost halved to 56.7 trillion yen by mid-1995. This corresponds broadly speaking to movements in the value of the stock market. But although the level of the Tokyo Stock Exchange 1st Section Topix index has more than halved since the end of 1989 and has traded sideways for almost three years, this does not necessarily make the market attractively valued. Given the decline in the decline in actual and expected earnings resulting from much lower nominal growth in national income, earnings-based valuations still look stretched. The market-capitalisation weighted average of P/E ratios averaged 55.38 times forecast earnings in October 1995, slightly higher than the 1989 calendar-year average P/E ratio of 54.69 times forecast earnings and only 8% below the December 1989 peak valuation of 60.11 times. The low earnings yield may compare favourably with Japan's present historically low nominal short-term interest rates, but compares less favourably with real long-term interest rates, which remain high due to a steep yield-curve and ongoing deflation. Price-to-book valuations of the Japanese market are tricky as there is a lot of circularity with cross holdings of shares, and as the value of land is subject to question given the illiquidity of the property market and the overhang of unsold collateral from banks' bad loans. Given this continued fundamental unattractiveness of Japanese equities, we think it would be dangerous to view (as some observers do) the recent increase in demand for cash and M1 as a precursor to renewed massive buying of domestic stocks by Japanese savers.

The continued growth in the share of insurance policies in overall personal savings has been due to the ability of insurance companies to offer new policy holders high 'pledged rates of return' in excess of the actual rates of return they are making on the additional funds sourced. Their ability to do this hinges on their ability to smooth out fluctuations in actual rates of return on assets by building up and drawing down substantial cushions of hidden reserves (i.e. unrealised, and therefore unaccounted for, capital gains). In effect this amounts to using the capital gains from existing policies to subsidise new policies. In the case of mutually owned insurance companies this is tantamount to robbing unwitting shareholders of what is rightfully their capital. However, the practice has given insurance companies a competitive edge in the market for personal savings and allowed them to increase their market share from 15% at the end of 1985 to 24% at the end of 1994. Given the lack of disclosure about the true market value of insurance companies' balance sheets, it is difficult to assess the true scale of their hidden reserves, and the extent to which they can continue the cross-subsidisation of new policy holders.

Investment Trusts now account for only 3% of personal savings, but from 1985 to 1988 they almost doubled that share from 3.5% to 6.5%. Investment trusts were one of the few savings instruments where the post-1989 collapse of asset prices was properly felt in the value of the savings instrument itself. Until mid-1995, international investment trusts have suffered from the handicap of an ever-strengthening yen added to the volatility of overseas markets and the inability to guarantee a positive rate of return. The weakening of the yen in the second half of 1995 has, however, increased Japanese savers appetite for exposure to overseas markets. Combined with deregulation of the investment trust business, we therefore expect to see a significant increase in the share of investment trusts in total savings, with investment trusts oriented towards foreign equities and bonds gaining market share.

During the process of deflation and declining short-term interest rates Japanese Government Bonds (JGBs) have rallied strongly, bringing the 10 year yield down below 3%. Although such rates still present an attractive yield gap of almost 2.5% above short-term rates, the low absolute levels of the bond yield places a limit on the scope for further capital

gains on government bonds. In addition, although only a few months ago the government was busy proclaiming record fiscal expansion packages, recent noises from Ministry of Finance officials have expressed concern at the escalating levels of government deficits and debt. Given the low absolute yields and the rising fiscal deficits, one can understand if Japanese investors are wary of putting their money into JGBs. Indeed, the proportion of domestic bonds in total personal savings has declined steadily over the past decade from 9.3% at the end of 1985 to 4.2% in mid-1995.

Bank deposits have maintained a broadly constant market share of total personal savings, hovering around 25%, while other deposit takers (except the post office - see below) have seen their market share decline modestly from 19.1% at the end of 1985 to 17.4% by mid-1995. However, although the aggregate of 'all banks' may have maintained a broadly constant share of personal savings on their deposit books, there has been a marked difference between the growth rates of deposits with different categories of banks. Compared to a year ago, deposits with city banks are unchanged, deposits with Trust Banks and Long Term Credit Banks have actually declined, while deposits with regional banks have increased, reflecting that at least some regional banks have less bubble-related bad loans and are thus in a stronger position to expand their balance sheets. More recently bank deposit rates have come down to almost negligible levels, while concern about the security of bank deposits has heightened in spite of government reassurances, to the point where the more dramatic commentators describe bank deposits as a 'moderate risk, no return' asset class. Given portfolio theory's assumed objective function of maximising risk-adjusted return, it should come as no surprise that at least some proportion of savers would choose to reduce the proportion of their savings which they hold in the form of bank deposits. Such a portfolio shift will, of course, affect not only the growth of bank deposits, but also the ability of banks to extend credit to both the financial and the real economy.

The popularity of post office savings is one of the few indicators available which suggests that Japanese savers have some sensitivity to credit risk, especially when there is less difference in the rates of return available on different savings instruments. From 1985 to 1990, the share of post office savings in total savings fell from 21.5% to 18%, while since then it has been steadily rising back to 21.5% by mid-1995. Although the government has made great efforts verbally to reassure savers of the safety of their bank deposits, savers are now more aware of possible credit risk among financial institutions. In the absence of prompt disclosure of comprehensive and transparent accounts of financial institutions, savers have little basis on which to make informed assessments of credit risk. An understandable reaction is therefore an increased demand for savings instruments which are government guaranteed or, better still, issued by the government. The only claims on the government which the personal sector have access to are Government Bonds (which can be difficult to transact, and which entail some market risk), Post Office Savings (conveniently available at local post offices, and with interest rates similar to bank deposit rates), and cash currency.

What is the Stance of Monetary Policy?

Although the BoJ has cut short-term interest rates to historically low levels, and the growth rate of narrow money has accelerated dramatically, this may not be quite enough to kickstart Japan's stalled economy. The BoJ's money market operations still appear to be aimed at smoothing out daily fluctuations and accommodating increases in cash demand while maintaining short-term interest rates closely below the ODR of 0.5%. When the overnight call rates have shown signs of falling lower, the BoJ has operated in the market to reduce the surplus and bring interest rates back in line with policy. Looking at the resulting

increase in monetary base, we find that most of it has been due to growth in currency in circulation, while bank reserves are virtually unchanged. In other words, the stance of monetary policy is still one of interest rate targeting with open market operations to accommodate rising demand for cash, rather than one of aggressive reflation aimed at increasing bank reserves and stimulating bank lending growth.

If the policy of low interest rates is not aimed at stimulating broad money growth and economic activity, what is it aimed at? Given the resistance to the use of public funds to resolve the problem of banks' bad loans, the low short term interest rates are probably aimed at keeping banks' cost of funds low, while higher long-term interest rates allow banks to earn wider operating margins. This trick of transferring money from the public sector and the non-bank private sector to the banking sector via a steep yield curve (and resulting wider operating margins for banks) is superficially quite reminiscent of what the US Federal Reserve did in the early 1990s.

Is This Like the United States in the Early 1990s?

Some observers interpret the recent rise in Currency and M1 as an extremely bullish signal for Japan's economy and financial markets, even in spite of the continued sluggish growth rates of M2+CDs. This interpretation of recent portfolio shifts is often supported by reference to the similar pattern in the mixed monetary indicators in the United States in the early 1990s, when during the resolution of the problems in the Savings and Loans Institutions, narrow monetary aggregates accelerated while broad aggregates decelerated. M2, or broad money as we knew it, had ceased to be a useful leading indicator of the direction of the economy and financial markets. However, these apparent similarities ignore a number of key differences between the US then and Japan now.

There are substantial differences between the definitions of different monetary aggregates in Japan and in the United States. Whereas Japan's M1 only includes cash currency and the non-bank sector's demand deposits with banks, US M1 includes in addition "other checkable deposits" (OCDs) which covers a vast array of "instant access" accounts with both banks and a wide range of non-bank financial institutions. This meant that the portfolio shift in the US in the early 1990s out of quasi-money into M1 was in part due to financial innovation (growth in OCDs), and was also soon accompanied by a pick-up in transactions in both the real economy and in financial markets. Japan has neither had the same kind of financial innovation, nor has the growth in M1 been accompanied by a pick-up in transactions. Rather, the switch has occurred as long-term time deposits have expired and been transferred into demand deposits, rather than being rolled over as new long-term time deposits.

The time when US M2 ceased to be a useful leading indicator of the US economy coincided with an acceleration in the growth of bond and equity mutual funds. Declining interest rates reduced the returns on savings deposits and increased the total returns on bonds and equities, which individuals could more conveniently invest in through increasingly competitive mutual funds. Although bond and equity mutual funds became a rapidly rising part of personal savings, they were not included in M2. However, by adjusting M2 for holdings of mutual funds, one can derive a measure which continued to serve as a useful leading indicator of nominal GDP. As noted earlier, Japan has not yet had a mutual funds boom.

To summarise the differences, the slowdown in broad money and pick-up in narrow money reflected different phenomena in Japan 1995 and in the United States in 1990-92. In Japan at present, it reflects liquidity-preference driven portfolio shifts within overall sluggish broad money demand. In the US in the early 1980s it reflected both portfolio-shifts within an outdated measure of broad money into greater liquidity (driven by both declining short rates and by a recovery in transactions) as well as portfolio shifts into instruments (e.g. bond and equity mutual funds) not included in M2, and hence M2 understated the growth in the private sector's holdings of money-like liquid assets.

Another key difference is the severity of the financial crisis and the degree of market distortions. The level of bad debts in the banking system is even by the government's own admission close to 10% of GDP, while the rather narrow and vague definition of bad debts used so far has lead many observers to suspect that the true level of bad debts is even higher. Even when Japanese banks do book losses on bad debt and transfer the bad debts to the Cooperative Credit Purchasing Corporation (CCPC), this does not resolve the bad debts. Whereas the Resolution Trust Corporation (RTC) in the United States liquidated the collateral from bad loans quite aggressively, the CCPC has so far only sold around 3% of the property used as collateral for the bad loans. Bureaucratic obstacles to bankruptcy proceedings (a precondition for claiming and disposing of the underlying collateral), a fear of depressing property prices further, and a lack of incentive for banks to dispose of collateral (as they can claim the tax benefit when they transfer the loan to the CCPC), are all factors preventing a full disposal of bad loans. Meanwhile land is tied up in virtually bankrupt property companies, capital is tied up in bad loans on the balance sheet of both banks and borrowers, and workers are tied to declining industries by an outdated employment system. Whereas in the United States already flexible markets for both land, labour and capital were reinvigorated by the activities of the RTC, Japan's factor markets all seem to be way above market clearing levels while the authorities try desperately to avoid falls in factor prices.

There are also crucial differences between government policy towards the problem-affected financial institutions. The United States has a comprehensive formal deposit insurance system, and a political consensus in favour of protecting depositors. Meanwhile, Japan's deposit insurance is still limited to the principal of deposits of less than Yen10 million (excluding accrued interest), although politicians have verbally guaranteed all deposits (at least of internationally active banks) at least until the year 2000. Also Japan's Deposit Insurance Corporation (DIC) appears grossly undercapitalised for the task at hand, even after the recent quadrupling of deposit insurance premiums, and some suggestions for a solution to banks' problems includes the use of DIC capital for purchasing paper issued by the banks whose deposits it is meant to insure. Moreover, public opinion in Japan is still strongly against the use of public funds to bail out banks.

It appears increasingly likely that the eventual solution to the problems affecting Japanese banks will involve an institution like the US RTC, possibly the Tokyo Kyodo Bank (set up last year to take over two Tokyo-based failed credit unions), as well as the continued subsidising of banks profit margins through low deposit rates and a steep yield curve (very much like in the United States). However, as long as public opinion remains against the use of public funds to bail out the banks, the provision of capital for any Japanese RTC-like institution will probably be through government guarantees on the borrowings of that institution, i.e. contingent liabilities rather than outright spending. However, when (as looks highly likely) these contingent liabilities fall due in the future, Japan will find that (like the US today), the use of public funds to solve the problems of the financial sector has caused a deterioration in government finances.

SUMMARY AND CONCLUSIONS: The recent sudden surge in Currency in Circulation and in M1 has been more a case of money diversion (out of quasi-money such as maturing time deposits) than of money creation by both the central bank and commercial banks. It does not reflect any increase in retail sales or other forms of transactions, but rather an increased liquidity preference of overall money demand due to lower interest rates and heightened perceptions of risks on other less liquid forms of money.

Money held in the form of cash cannot be intermediated into new credit by the banking system, especially not when the banking system is still in the process of dealing with an overhang of bad loans from the 1980s bubble. Although the cash mountain will not lie idle indefinitely, it is unlikely to enter the domestic equity market at current stretched valuations and unlikely to return to bank deposits until a credible solution is found to the problems in the banking system. However, the liquid balances may well be attracted to foreign asset classes, especially if the yen continues to weaken gradually.

The stance of monetary policy is still accommodative, aimed at targeting a policy level of interest rates (admittedly a very low level) rather than aggressively reflationary. Indicators to watch for further easing of monetary conditions are market interest rates, the yen/dollar exchange rate, the magnitude of surpluses in the money market (i.e. banks' excess reserves), and in due course an acceleration in broader monetary aggregates.

In the meantime, the sluggishness of broader monetary aggregates suggests that nominal economic growth will remain negligible during 1996. In the near term, a negative outlook for real economic activity is also suggested by real indicators such as the decline in the trade surplus, the slowdown in industrial production, the high inventory/shipment ratio, etc.

Claims of similarities with the United States in 1990 ignore several crucial differences, such as US financial innovation (especially the growth of MMFs) and differences in factor market flexibility.

THAILAND LOOKING BEYOND THE SLOWDOWN

Introduction

The Thai economy has been in throes of a tightening monetary environment throughout 1994 and 1995 evidenced by the 375 basis point rise in prime lending rates since February 1994. Loan rates in Thailand which have closely tracked US interest rates upwards in this cycle were lifted further after the Mexican peso crisis in January 1995. They have demonstrated little tendency to ease since that time, despite tentative signs of a slight slowdown in economic activity, and may rise again in the near future unless the torrid pace of investment and lending growth are brought under control. The Thai Baht's tight ties to the US dollar and the importance of the US as an export destination naturally emphasise the cyclical links between the two countries. However, rapid slowing of the US economy following seven Fed interest rate hikes to February 1995, and the easing of US interest rates in July, are not characteristics which have so far been echoed in Thailand. This article explores the extent to which a slowing of the economy is in prospect through 1996 as a result of monetary policy tightening so far. Essential to the analysis is an examination of the lags between monetary policy stimuli and real economic activity; an issue which has been considerably complicated in Thailand, and across Asia generally, over recent years by financial liberalisation and the volatility of global capital flows.

Growth so Far

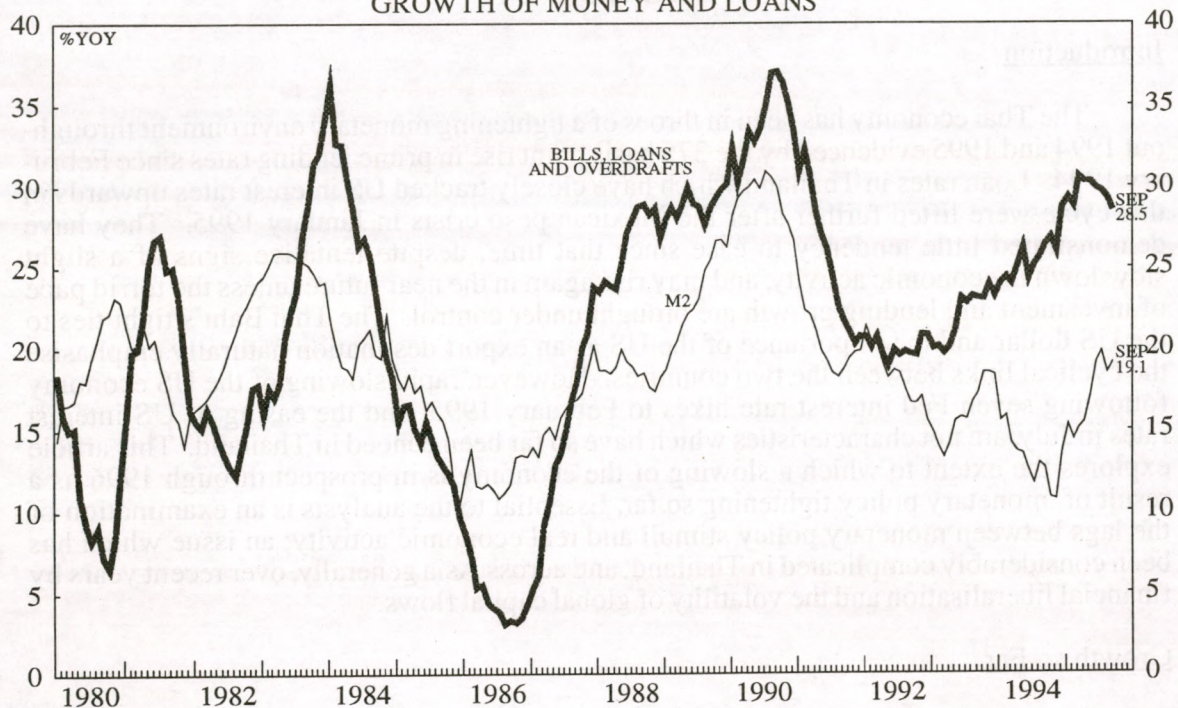
Table 1 below shows that after a modest slowdown in 1992 the Thai economy has been recovering strongly on the back of buoyant export activity and investment spending. The former was coupled with recoveries in the US, and subsequently in Europe, while the latter was fostered more by the huge capital inflows to ASEAN generally during 1992/93. Twin liquidity boosts from exports and overseas investment were obviously supportive of growth since 1992 but it is the additional impetus from access to cheap overseas finance, primarily through the Bangkok International Banking Facilities (BIBFs) which has fuelled potentially explosive lending activity since 1993. The inflationary consequences of these ongoing external liquidity injections, and their negative impact on a burgeoning trade balance, prompted the Bank of Thailand (BoT) to implement measures this year directly limiting such inflows. Nevertheless, lending growth has forged ahead in 1995 (Chart 1) although its rate of growth looks to be stabilising at high levels relative to GDP growth.

Table 1
Growth Highlights to 1994

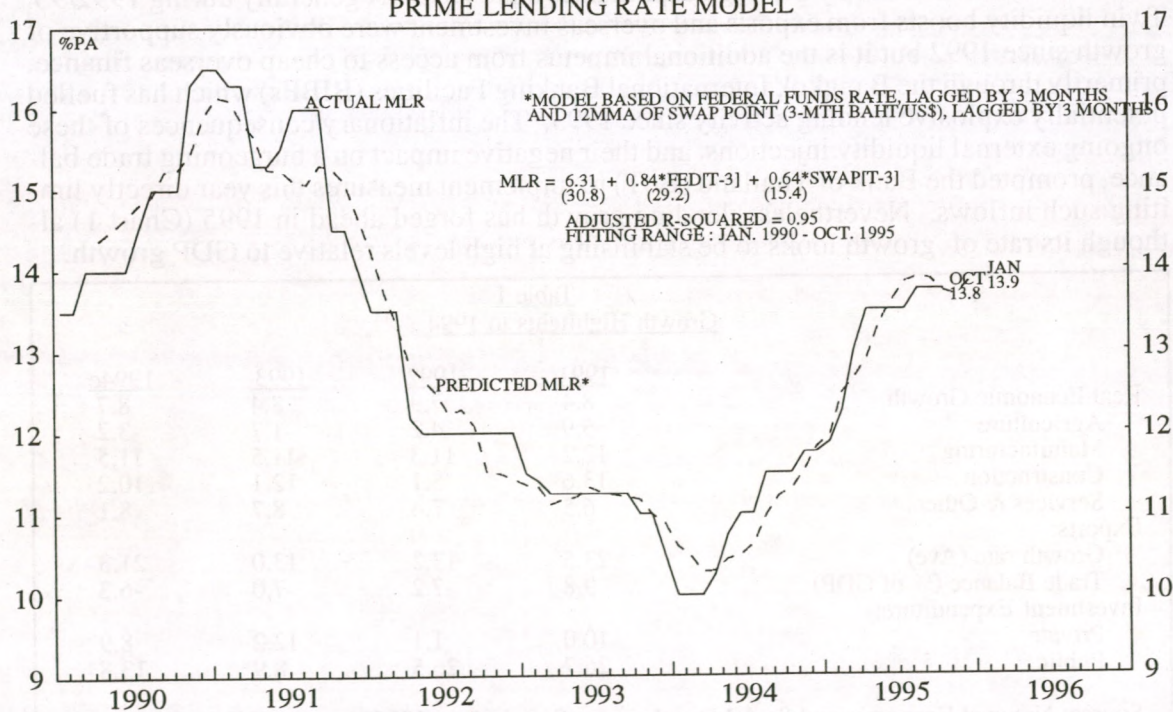
	1991	1992	1993	1994e
Real Economic Growth	8.4	7.9	8.4	8.7
Agriculture	5.9	4.2	-1.7	3.2
Manufacturing	12.2	11.3	11.5	11.5
Construction	13.6	5.1	12.1	10.2
Services & Others	6.5	7.4	8.7	8.1
Exports:				
Growth rate (Ave)	23.5	13.2	13.0	21.3
Trade Balance (% of GDP)	-9.8	-7.2	-7.0	-6.3
Investment Expenditure:				
Private	10.0	1.1	12.2	8.9
Public	26.7	26.5	8.9	13.8

Source: National Economic and Social Development Board (Aug. 1995)
e = estimate

THAILAND: CHART 1
GROWTH OF MONEY AND LOANS



THAILAND: CHART 2
PRIME LENDING RATE MODEL



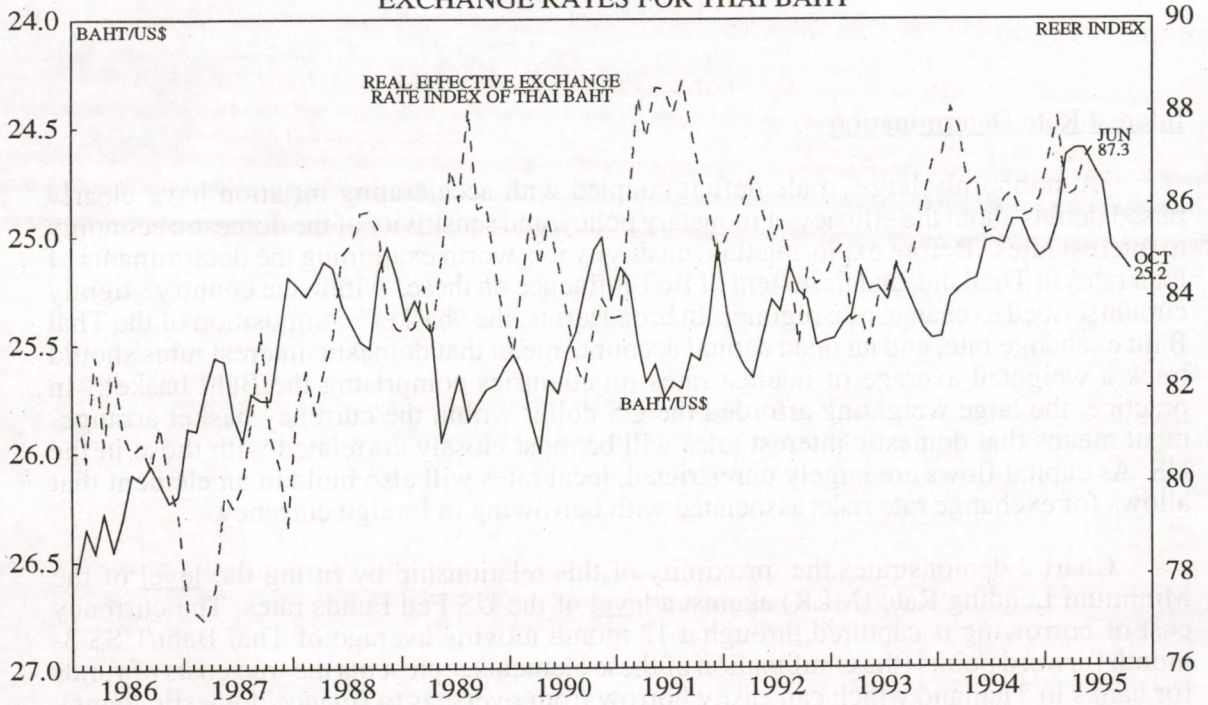
Interest Rate Determination

A stubbornly large trade deficit coupled with accelerating inflation have clearly raised doubts about the efficacy of monetary policy, and sensitivity of the domestic economy to interest rates. Before exploring this sensitivity it is worth examining the determinants of loan rates in Thailand, and the extent of BoT influence on these, within the country's tightly circumscribed exchange rate regime. In broad terms, the "basket" composition of the Thai Baht exchange rate, and an open capital account, mean that domestic interest rates should track a weighted average of interest rates in countries comprising the Baht basket. In practice, the large weighting afforded the US dollar within the currency basket arrangement means that domestic interest rates will be most closely correlated with those in the US. As capital flows are largely unrestricted, local rates will also build in an element that allows for exchange rate risks associated with borrowing in foreign currency.

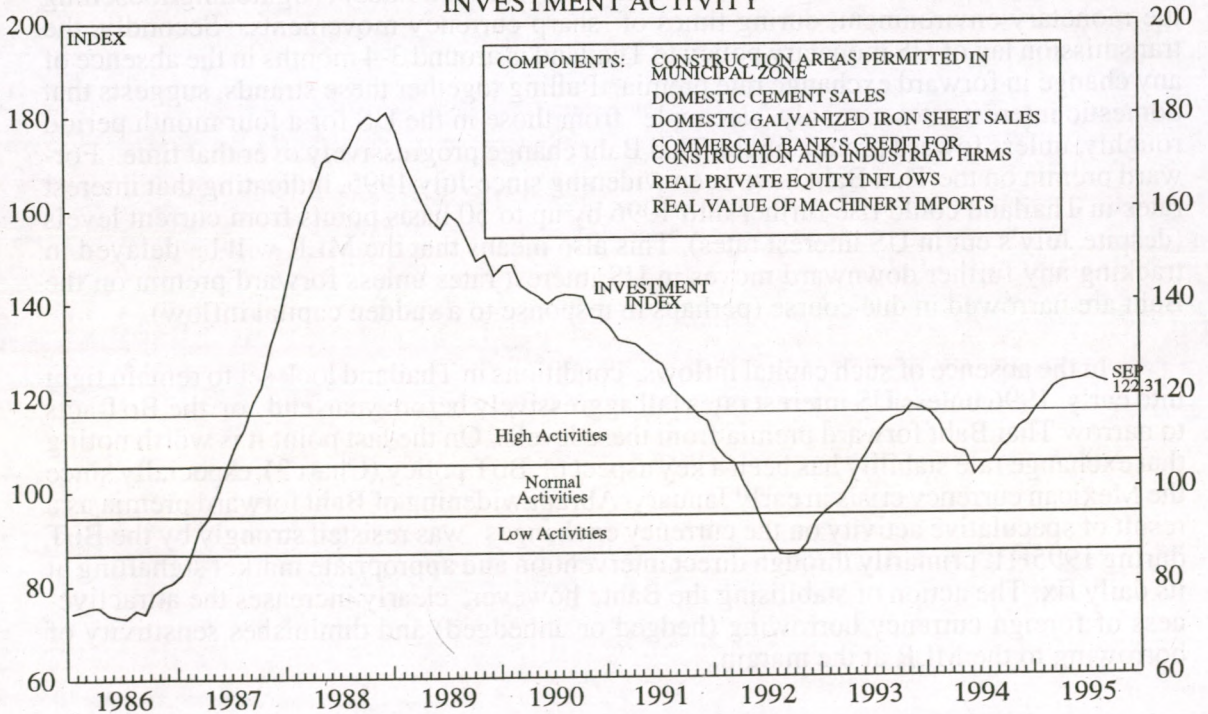
Chart 2 demonstrates the proximity of this relationship by fitting the level of the Minimum Lending Rate (MLR) against a level of the US Fed Funds rates. The currency cost of borrowing is captured through a 12 month moving average of Thai Baht/US\$ 3-month forward points (the combination of these elements represents the true costs of funds for banks in Thailand which can easily borrow from overseas to finance domestic loans). Two salient points are worth highlighting. Firstly, that the BoT can influence the cost of funds for banks in Thailand, and therefore their respective MLRs, by manipulating Baht/US\$ foreign exchange rate premia. Left to themselves, these premia should widen/narrow automatically (as spot exchange rates deviate from forward rates), tightening/loosening the monetary environment, during times of sharp currency movements. Secondly, the transmission lag of US monetary policy to Thailand is around 3-4 months in the absence of any change in forward exchange rate premia. Pulling together these strands, suggests that domestic interest rates can only "decouple" from those in the US for a four month period roughly, unless forward premia on the Thai Baht change progressively over that time. Forward premia on the Thai Baht have been widening since July 1995, indicating that interest rates in Thailand could rise further into 1996 by up to 50 basis points from current levels (despite July's cut in US interest rates). This also means that the MLR will be delayed in tracking any further downward moves in US interest rates unless forward premia on the Baht are narrowed in due course (perhaps in response to a sudden capital inflow).

In the absence of such capital inflows, conditions in Thailand look set to remain tight into early 1996 unless US interest rates fall aggressively before year-end, or the BoT acts to narrow Thai Baht forward premia from these levels. On the last point it is worth noting that exchange rate stability has been a key aspect of BoT policy (Chart 3), especially since the Mexican currency crisis in early January. Abrupt widening of Baht forward premia as a result of speculative activity on the currency exchanges was resisted strongly by the BoT during 1995H1, primarily through direct intervention and appropriate market signalling at its daily fix. The action of stabilising the Baht, however, clearly increases the attractiveness of foreign currency borrowing (hedged or unhedged) and diminishes sensitivity of borrowing to the MLR at the margin.

THAILAND: CHART 3
EXCHANGE RATES FOR THAI BAHT



THAILAND: CHART 4
INVESTMENT ACTIVITY



Interest rate Sensitivity and the Transmission mechanisms

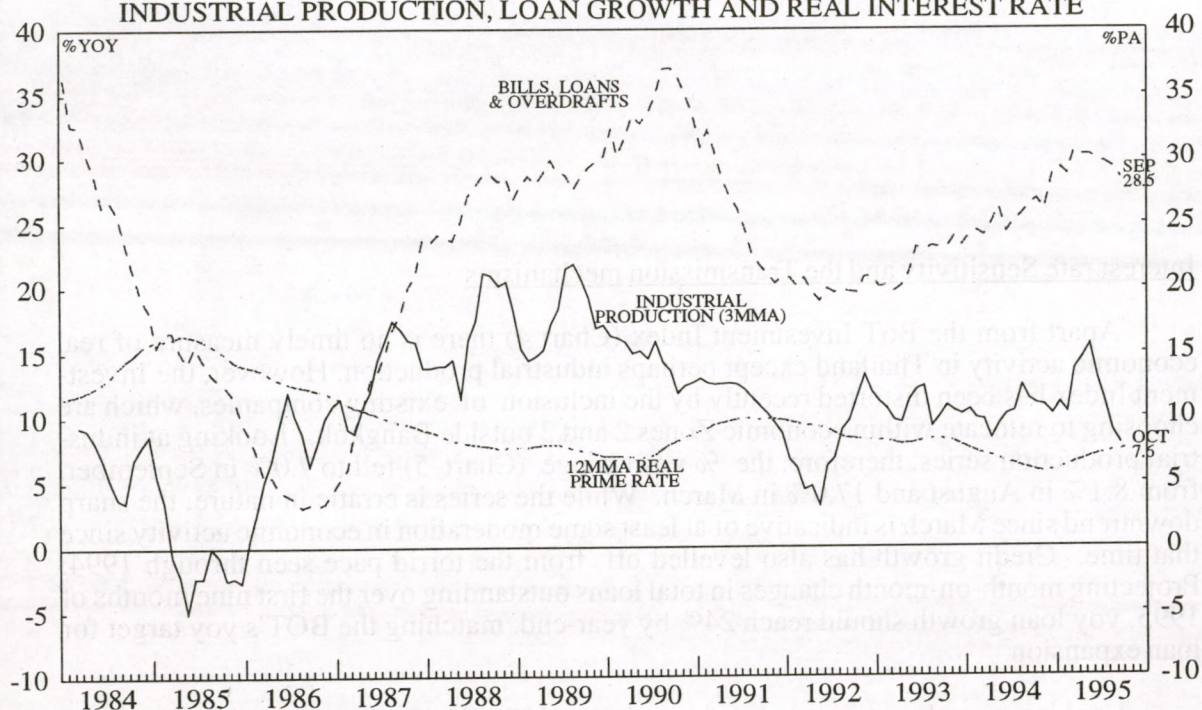
Apart from the BoT Investment Index (Chart 4) there is no timely measure of real economic activity in Thailand except perhaps industrial production. However, the Investment Index has been distorted recently by the inclusion of existing companies, which are choosing to relocate within economic Zones 2 and 3 outside Bangkok. Looking at industrial production series, therefore, the % yoy change (Chart 5) fell to 7.0% in September, from 8.1% in August and 17.0% in March. While the series is erratic in nature, the sharp downtrend since March is indicative of at least some moderation in economic activity since that time. Credit growth has also levelled off from the torrid pace seen through 1994. Projecting month-on-month changes in total loans outstanding over the first nine months of 1995, yoy loan growth should reach 24% by year-end, matching the BOT's yoy target for loan expansion.

Looking over the previous slowdown during 1989-91 (Chart 5), the deceleration of industrial production which began in 1989 was especially acute in 1991. This followed the Gulf crisis and a 300 basis point rise in the real interest rate, to over 10.6%, in 1990. Loan growth peaked around 1990 Q3 and then decelerated alongside the collapse of industrial production. The bounce in industrial production in 1992 H2 was also noticeable as real rates tumbled during and after 1991 H2. History suggests therefore that both industrial production and loan growth are highly responsive to the average level of domestic real interest rates over a 12 month period, although the "pain threshold" for both is high. On this basis, the deceleration of industrial production in 1995 is not surprising, but any further slowdown of underlying economic activity is likely to be gradual; responding to real interest rates which have been low by historic standards. Similarly, in the current cycle, the down-leg in loan growth is likely to be less pronounced than in 1990/91, mitigated partly by our earlier observations about the diminished sensitivity of loan growth to interest rates since 1993 (because of relative stability of the Baht).

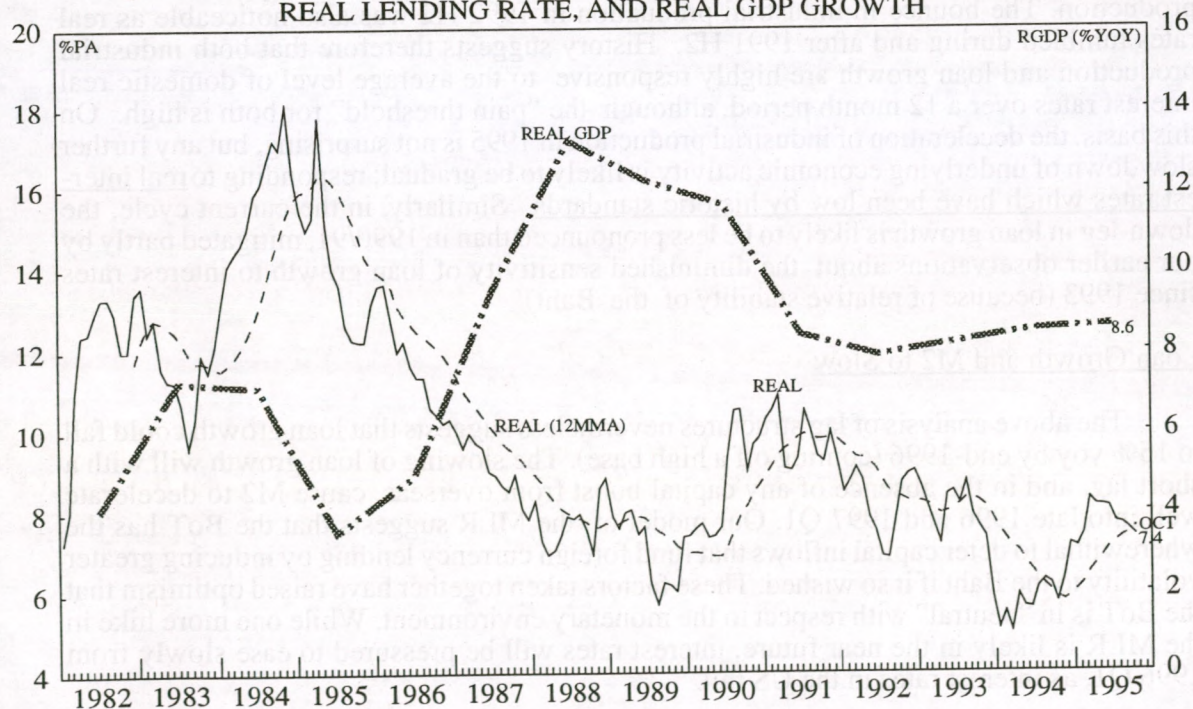
Loan Growth and M2 to Slow

The above analysis of lag structures nevertheless suggests that loan growth could fall to 15% yoy by end-1996 (coming off a high base). The slowing of loan growth will with a short lag, and in the absence of any capital boost from overseas, cause M2 to decelerate well into late 1996 and 1997 Q1. Our model of the MLR suggests that the BoT has the wherewithal to deter capital inflows that fund foreign currency lending by inducing greater volatility to the Baht if it so wished. These factors taken together have raised optimism that the BoT is in "neutral" with respect to the monetary environment. While one more hike in the MLR is likely in the near future, interest rates will be pressured to ease slowly from 1996 Q1, as interest rates in the US fall.

THAILAND: CHART 5
INDUSTRIAL PRODUCTION, LOAN GROWTH AND REAL INTEREST RATE



THAILAND: CHART 6
REAL LENDING RATE, AND REAL GDP GROWTH



Monetary Policy Tightening

Much of BoT monetary policy action in 1995 has been aimed at generally raising interest rate sensitivity of the economy. Supervisory restrictions introduced earlier in the year, following the Mexican crisis, and differential reserve requirements later in July were directed at limiting foreign currency borrowing generally. Recent measures have been more discriminatory, specifically restricting foreign currency lending to "unproductive" sectors of the economy (certain types of real estate and the consumer generally). These sectors are then compelled to borrow on-shore, Thai Baht funds, at penal domestic interest rates. The policy announcements in July were fortuitously followed by a widening of exchange rate risk premia, as nervous foreign capital took flight against the backdrop of deteriorating domestic economic fundamentals.

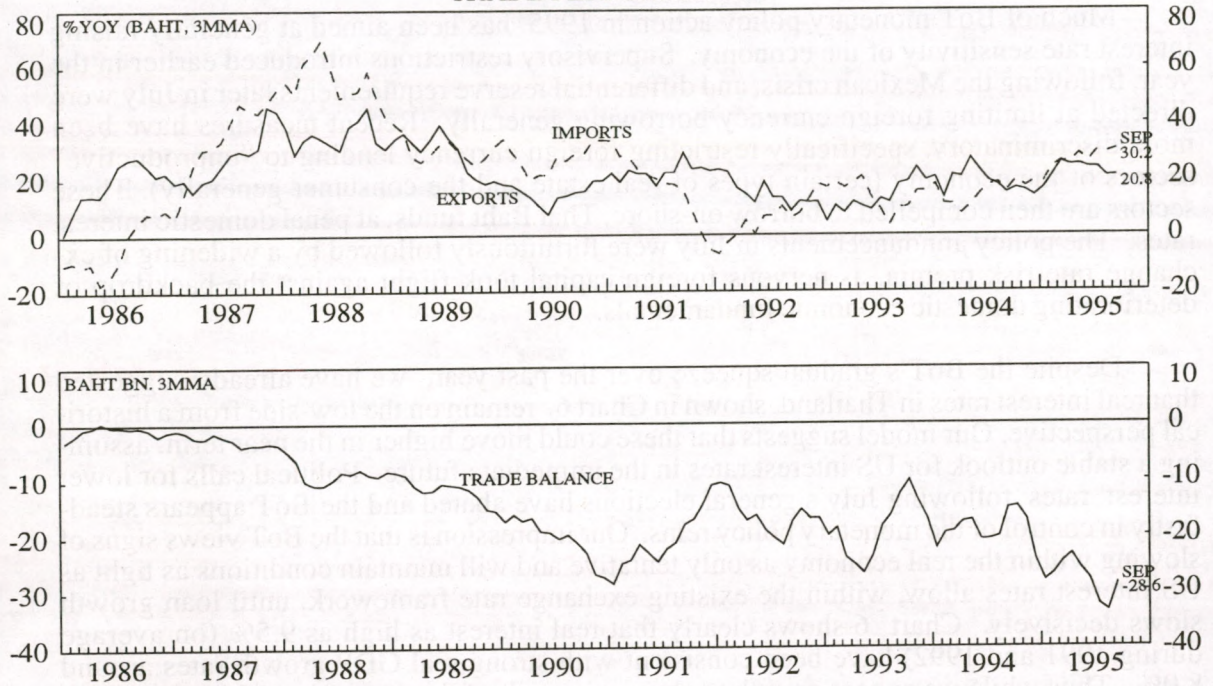
Despite the BoT's gradual squeeze over the past year, we have already suggested that real interest rates in Thailand, shown in Chart 6, remain on the low-side from a historical perspective. Our model suggests that these could move higher in the near term, assuming a stable outlook for US interest rates in the immediate future. Political calls for lower interest rates following July's general elections have abated and the BoT appears steadfastly in control of the monetary policy reins. Our impression is that the BoT views signs of slowing within the real economy as only tentative and will maintain conditions as tight as US interest rates allow, within the existing exchange rate framework, until loan growth slows decisively. Chart 6 shows clearly that real interest as high as 9.5% (on average during 1991 and 1992) have been consistent with strong real GDP growth rates around 8.0%. Thus while we expect growth to slow as a result of the upturn in real interest rates during 1995, the impact is likely to be only moderate -- GDP falling to perhaps 8.0% by end-1996.

The Trade Deficit and Inflation

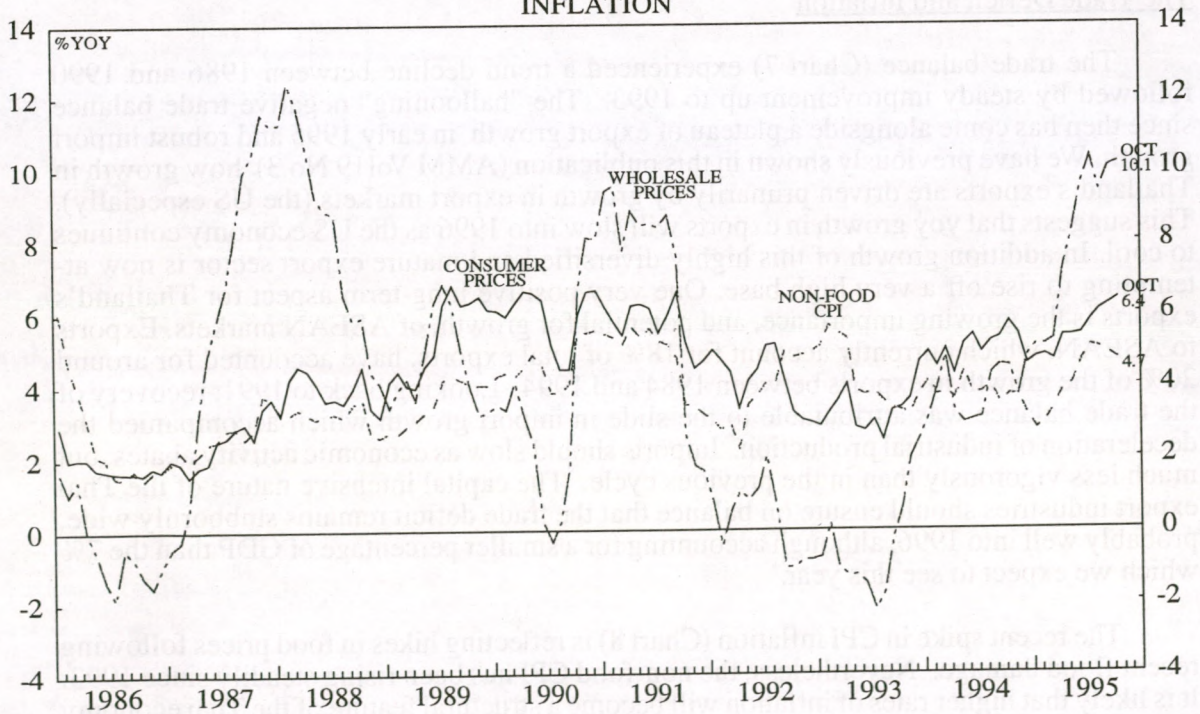
The trade balance (Chart 7) experienced a trend decline between 1986 and 1990 followed by steady improvement up to 1993. The "ballooning" negative trade balance since then has come alongside a plateau of export growth in early 1995 and robust import growth. We have previously shown in this publication (AMM Vol19 No.3) how growth in Thailand's exports are driven primarily by growth in export markets (the US especially). This suggests that yoy growth in exports will slow into 1996 as the US economy continues to cool. In addition growth of this highly diversified and mature export sector is now attempting to rise off a very high base. One very positive long-term aspect for Thailand's exports is the growing importance, and potential for growth, of ASEAN markets. Exports to ASEAN, which currently account for 18% of total exports, have accounted for around 20% of the growth in exports between 1984 and 1994. Looking back to 1991, recovery of the trade balance was attributable to the slide in import growth which accompanied the deceleration of industrial production. Imports should slow as economic activity abates, but much less vigorously than in the previous cycle. The capital intensive nature of the Thai export industries should ensure on balance that the trade deficit remains stubbornly wide, probably well into 1996, although accounting for a smaller percentage of GDP than the 7% which we expect to see this year.

The recent spike in CPI inflation (Chart 8) is reflecting hikes in food prices following recent flood damage. Nevertheless, the non-food CPI has been rising steadily since 1993. It is likely that higher rates of inflation will become a structural feature of the Thai economy henceforth, as the service sector expands and the economy transitions generally into higher productivity activities.

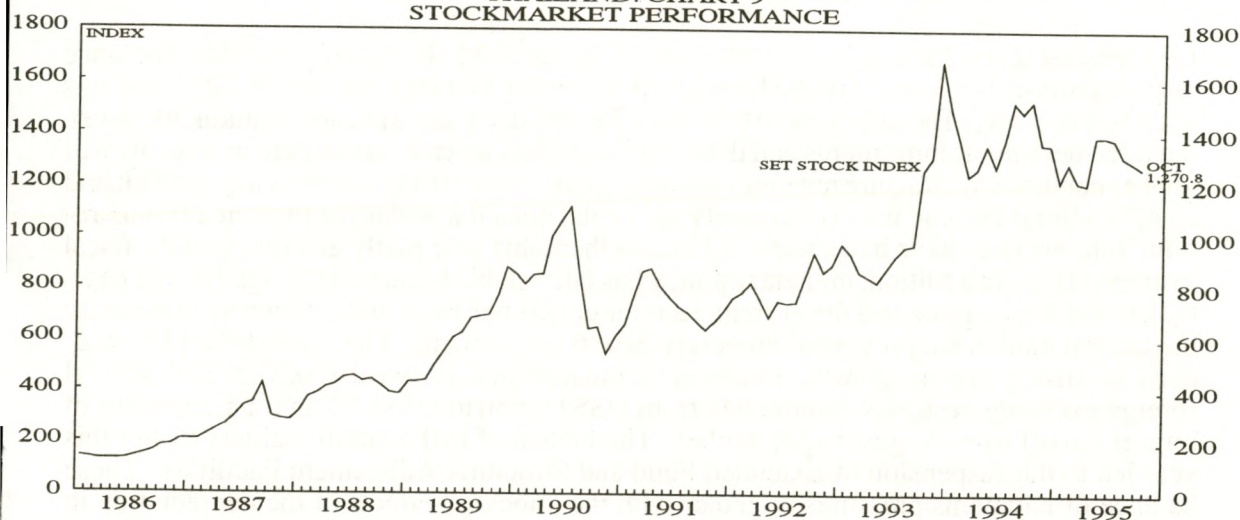
THAILAND: CHART 7
TRADE PERFORMANCE



THAILAND: CHART 8
INFLATION



THAILAND: CHART 9
STOCKMARKET PERFORMANCE



Corporate Earnings

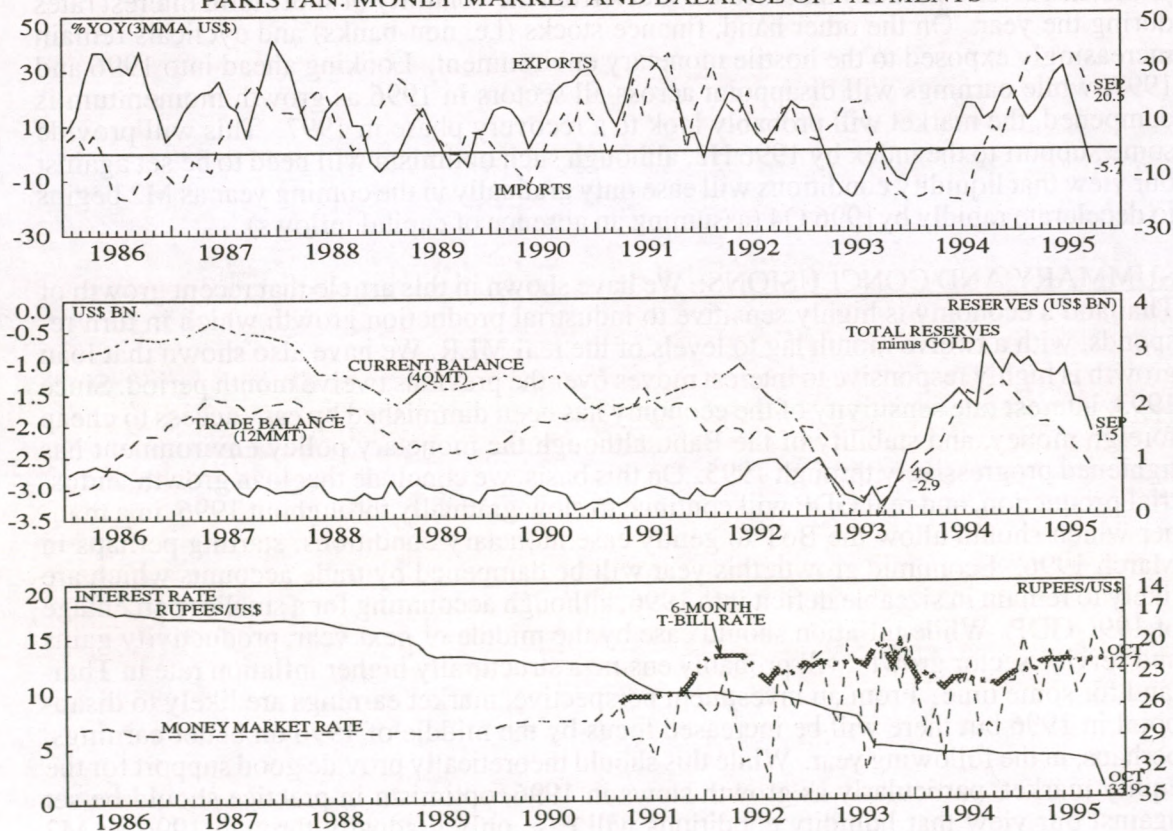
Corporate earnings in Thailand since economic recovery gathered momentum in 1992 have been somewhat erratic from quarter to quarter although broadly consistent with the ebb and flow of industrial production. The predominance of banking stocks within the SET index (Chart 9) and their ability to maintain attractive spreads during the high interest phase, has at least partially shielded the index from the volatility of short-term interest rates during the year. On the other hand, finance stocks (i.e. non-banks) and cyclicals remain increasingly exposed to the hostile monetary environment. Looking ahead into 1996 and 1997, while earnings will disappoint across all sectors in 1996 as growth momentum is dampened, the market will probably look to a recovery phase in 1997. This will provide some support to the index by 1996 H2, although such optimism will need to be set against our view that liquidity conditions will ease only gradually in the coming year as M2 begins to decelerate rapidly by 1996 Q4 (assuming an absence of capital inflows).

SUMMARY AND CONCLUSIONS: We have shown in this article that recent growth of Thailand's economy is highly sensitive to industrial production growth which in turn responds, with a twelve month lag to levels of the real MLR. We have also shown that loan growth is highly responsive to interest moves over the previous twelve month period. Since 1993, interest rate sensitivity of the economy has been diminished by easy access to cheap foreign money, and stability of the Baht, although the monetary policy environment has tightened progressively through 1995. On this basis, we conclude that loan growth, industrial production, and real GDP will continue to slow gradually throughout 1996, in a manner which should allow the BoT to gently ease monetary conditions; starting perhaps in March 1996. Economic growth this year will be dampened by trade accounts which are likely to remain in sizeable deficit into 1996; although accounting for a smaller percentage of 1996 GDP. While inflation should ease by the middle of next year, productivity gains and service sector growth will probably ensure a structurally higher inflation rate in Thailand for some time. From an investment perspective, market earnings are likely to disappoint in 1996 but there will be increased focus by the middle of 1996 on better earnings, perhaps, in the following year. While this should theoretically provide good support for the equity market, particularly as growth slows in 1996, optimism in practice should be set against our view that liquidity conditions will ease only gradually through 1996 as M2 decelerates.

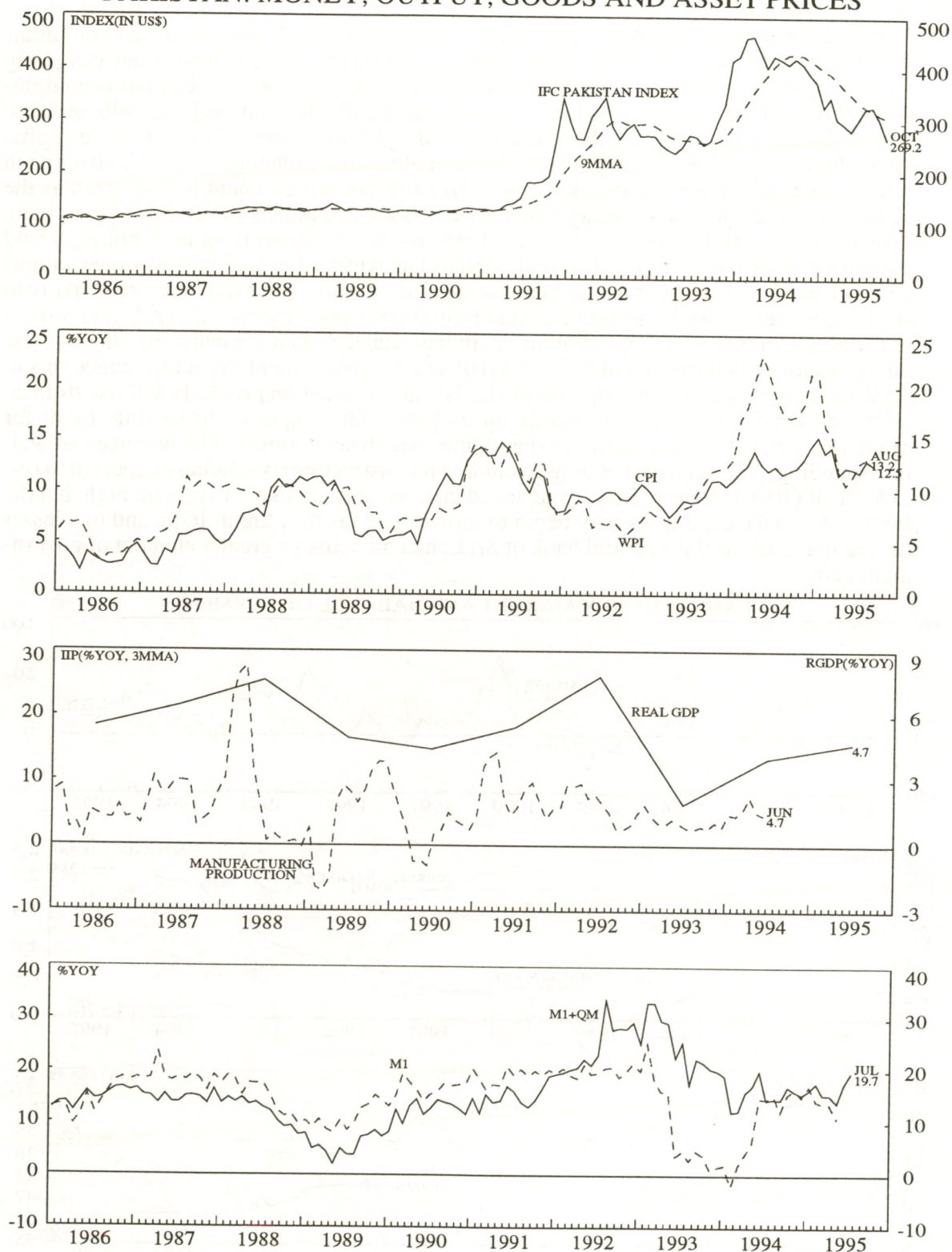
PAKISTAN: BALANCE OF PAYMENTS CRISIS

Like the rest of the India subcontinent region Pakistan is having its own fiscal and balance of payments difficulties. The budget deficit target for 1994/95 was 4% of GDP, but this overshoot to 5.5%. The target for 1995/96 (at 5% of GDP) also appears unattainable given the large defence commitments and debt servicing costs (each equivalent to around 30% of total expenditures). Raising revenues through greater tax collection is proving difficult and an agricultural income tax is effectively out of the question under the present administration. Interest rates have had an upward bias to them this year partly as a result of the fiscal overspending. In addition, monetary policy has been stable because although foreign capital has left the country and the current account deficit has been under downward pressure the central bank have prevented monetary base from slowing. The trade deficit has widened as strong import growth continues to outstrip that in (weak) exports and official foreign exchange reserves plummeted from US\$2.05 bn to US\$1.52 bn (or 1.2 months of import cover) from August to September. The breach of IMF conditionalities earlier this year led to the suspension of Extended Fund and Structural Adjustment Facilities. These balance of payments pressures, together with the knock-on effects of the depreciation in the Indian Rupee and the ongoing political uncertainties prompted the authorities to devalue the Pak Rupee/US\$ rate by 7% in October. Emergency consultations with the IMF in November resulted in the granting of a standby loan (valid for 15 months) of US\$600m. In an effort to clampdown on imports a blanket 10% import duty surcharge has been imposed. Given the overall weakness in exports the Rupee will likely continue to take further balance of payments strain and IMF help will continue to be necessary to alleviate high foreign debt servicing obligations.

PAKISTAN: MONEY MARKET AND BALANCE OF PAYMENTS



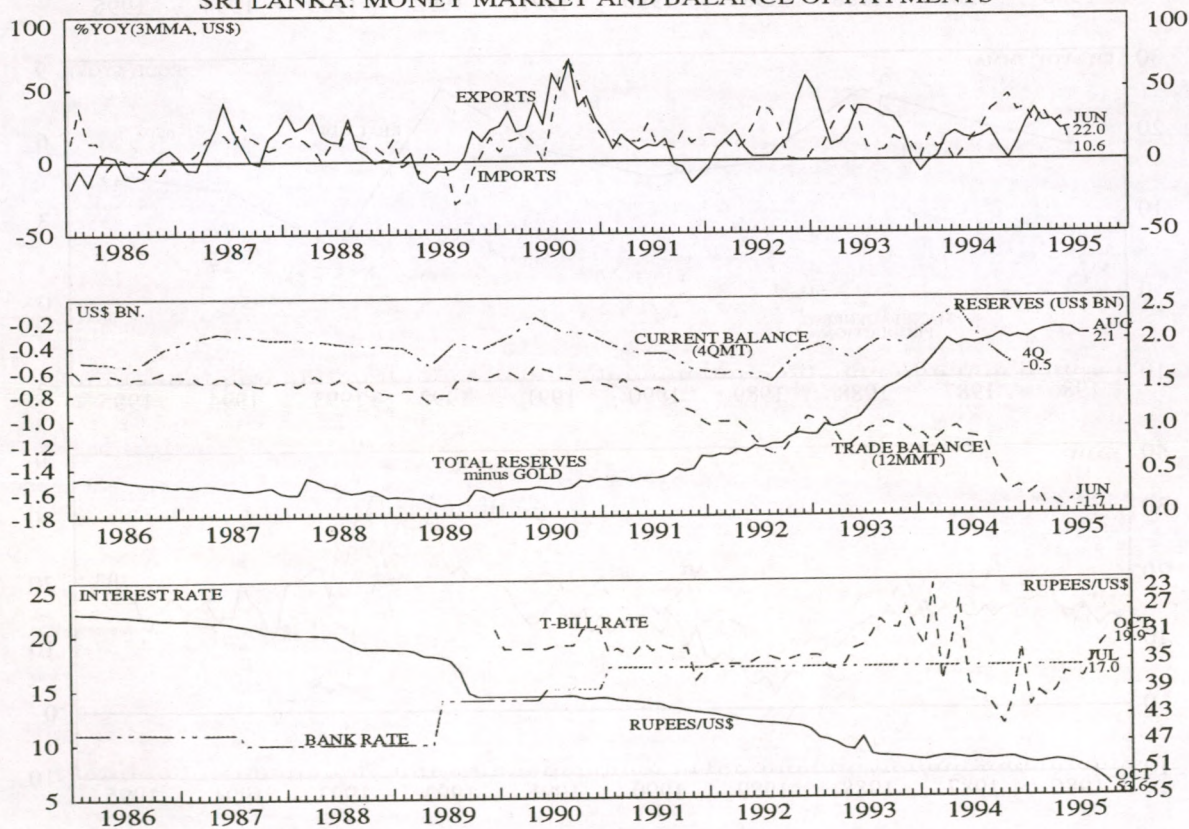
PAKISTAN: MONEY, OUTPUT, GOODS AND ASSET PRICES



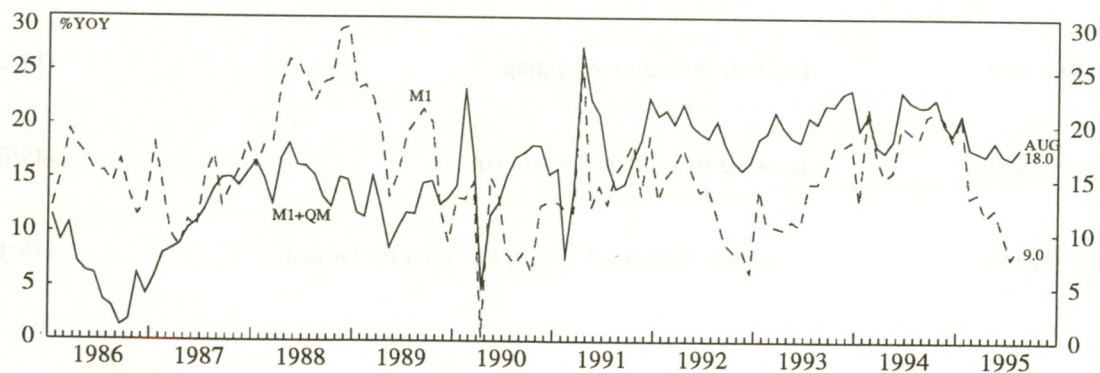
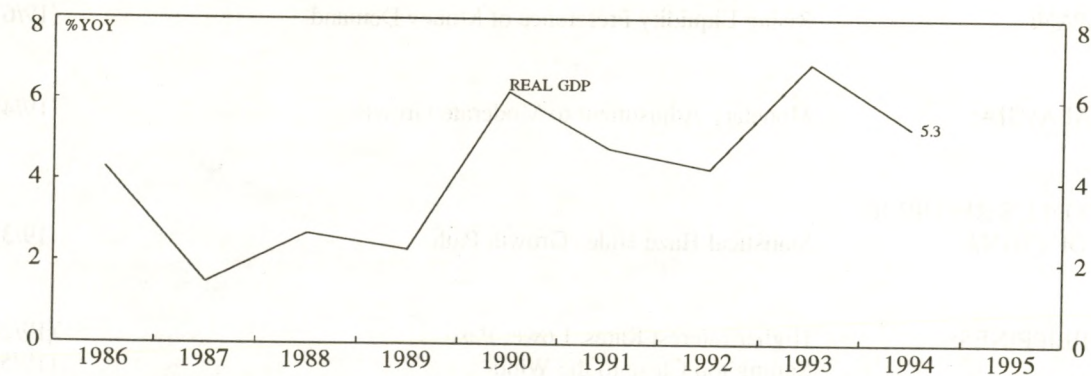
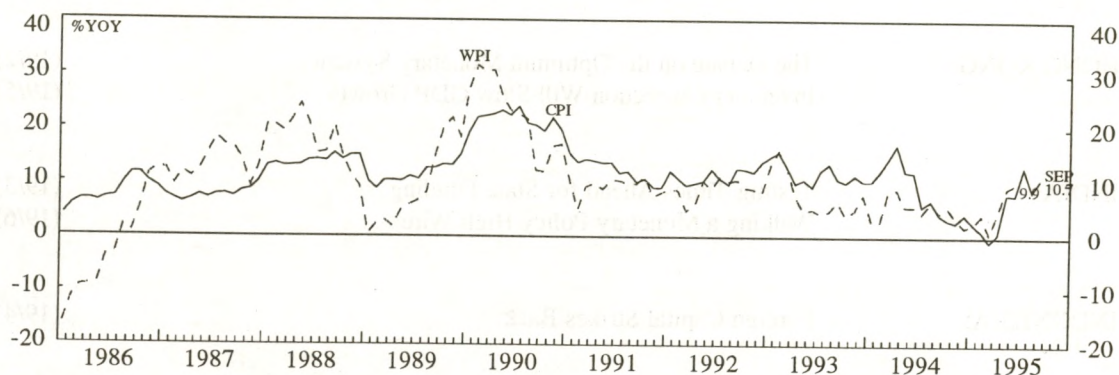
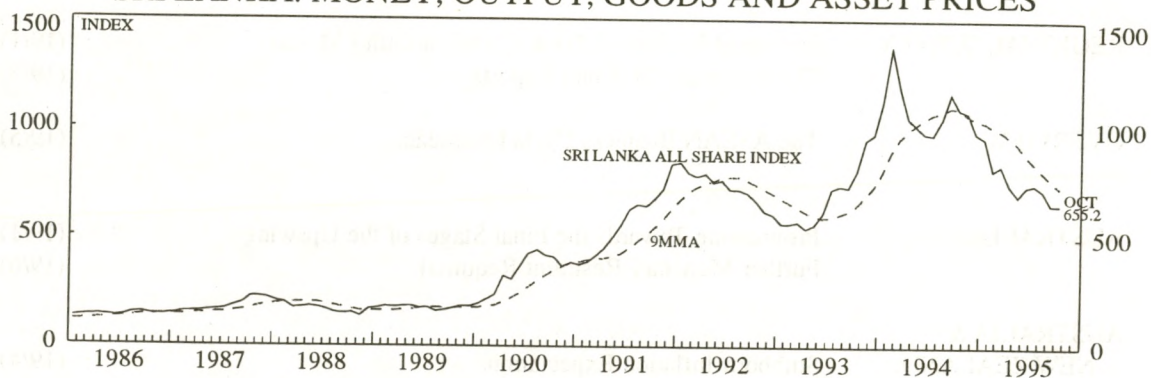
SRI LANKA: WARTIME COSTS RAISE FISCAL DEFICIT

The economy is experiencing the delayed effects of the relatively easy monetary conditions in 1993-94 in the form of strong bank credit growth and buoyant economic activity along with an upswing in the rate of inflation. However in 1995 monetary policy has been tightening (broad money has edged down) although this is unlikely to intensify in 1996. Against the background of a fairly rigid exchange rate of \$50/Rupee, the influx of foreign capital throughout 1993-94 led to a rapid accumulation of foreign exchange reserves, a decline in interest rates and huge stockmarket gains. In 1995 this environment has reversed as the authorities have allowed monetary base growth to slow and monetary conditions to tighten. This together with the increased political risk has led to sharp rises in T-bill rates and continued stockmarket falls. The trade deficit has widened in line with stronger import demand and the exchange rate has taken some of the strain. The exchange rate is likely to continue to weaken as the accumulation of foreign exchange reserves slows, local political uncertainty continues and pressure on the Indian Rupee remains downward. In 1995 the public sector deficit registered 9.2% of GDP and the government expect to reduce this to 7.8% next year on the (overly optimistic) basis that privatisation proceeds will rise from an estimated Rp 5 bn this year to Rp 21 bn in 1996. There appears to be little room for reduction in fiscal current account expenditures which are dominated by defence and welfare spending. War related spending (including reconstruction) is officially expected to rise to 5.8% of GDP next year. In the year ahead interest rates are likely to remain high, but the tighter monetary conditions may begin to turn around (as they are in India and to a lesser degree in Pakistan) if the central bank of Sri Lanka monetises a greater element of government debt.

SRI LANKA: MONEY MARKET AND BALANCE OF PAYMENTS



SRI LANKA: MONEY, OUTPUT, GOODS AND ASSET PRICES



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